No. 01-1209-CFX Title: The Boeing Company and Consolidated Subsidiaries, Petitioners
v.
United States

Docketed:
February 21, 2002 Court: United States Court of Appeals for the Ninth Circuit

Vide:
01-1382

Entry	Date	Proceedings and Orders
	Feb 15 2002	Petition for writ of certiorari filed. (Response due April 24, 2002)
	Mar 18 2002	Order extending time to file response to petition until April 24, 2002.
	Mar 21 2002	Brief amicus curiae of Tax Executives Institute, Inc. filed.
	Apr 24 2002	Brief of respondent United States in opposition filed.
	Apr 24 2002	Brief amici curiae of Brunswick Corporation, et al. filed.
	May 6 2002	Reply brief of petitioners Boeing Company and Consolidated Subsidiaries filed. VIDED.
	May 7 2002	DISTRIBUTED for Conference of May 23, 2002
	May 28 2002	Petition GRANTED. The cases are consolidated and a total of one hour is allotted for oral argument. SET FOR ARGUMENT December 9, 2002.
		**********
	Jul 2 2002	Motion of Boeing Co., et al. to dispense with printing the joint appendix filed.
	Jul 5 2002	Order extending time to file petitioners' brief on the merits to and including August 12, 2002.
	Aug 9 2002	Brief amicus curiae of Tax Executives Institute, Inc. filed.
	Aug 12 2002	Brief of petitioners Boeing Company and Consolidated Subsidiaries filed.
	Aug 12 2002	Brief amici curiae of Caterpillar Inc., et al. filed.
	Aug 12 2002	Brief amicus curiae of National Foreign Trade Council, Inc. filed.
	Aug 26 2002	Motion of Boeing Co., et al. to dispense with printing the joint appendix GRANTED.
	Sep 3 2002	Order extending time to file government's brief on the merits to and including October 10, 2002.
	Oct 4 2002	Brief of respondent United States filed. VIDED.
	Oct 28 2002	Record filed.
	Oct 29 2002	Record filed.
	Nov 6 2002	Reply brief of petitioners Boeing Company and Consolidated Subsidiaries filed.
	Nov 7 2002	CIRCULATED.
	Dec 9 2002	ARGUED.

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Supreme Court, U.S.
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OFFICE OF THE CLERK

No.

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Ninth Circuit, in direct conflict with the Eighth Circuit, correctly concluded that Treas. Reg. § 1.861-8(e)(3), which governs the allocation of research and development costs between foreign and domestic income, may be applied to the computation of taxable income for export subsidiaries entitled to special tax treatment under the Internal Revenue Code.

RULES 14.1 AND 29.6 STATEMENT

The parties to this proceeding are The Boeing Company and Consolidated Subsidiaries and Boeing Sales Corporation. Boeing Sales Corporation is a wholly-owned subsidiary of The Boeing Company. No publicly held company owns 10% or more of The Boeing Company's stock.

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*,1a-14a) is reported at 258 F.3d 958. The opinion of the district court (App., *infra*, 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001, and a timely petition for rehearing was denied on November 19, 2001 (App., *infra*, 25a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. § 994, 26 U.S.C. § 861, 26 C.F.R. § 1.994-1, and 26 C.F.R. § 1.861-8 are reprinted in the appendix to this petition at 26a-53a.

STATEMENT

This case concerns successive sets of tax provisions enacted by Congress to encourage exports by partially deferring or exempting taxation of income from export sales. Two principles control the measurement of the export income eligible for this special tax treatment. First, expenses are to be deducted from the export sales income to which those expenses are factually related, rather than from other gross income to which the expenses are not factually related. Second, to maximize tax benefits and thus to enhance the export incentives, taxpayers are permitted to group their income and expenses by recognized industry product line classifications.

The decision below departs from both of these principles. Under the rule announced by the Ninth Circuit, taxpayers are required to allocate or apportion research and development ("R&D") expenses according to broad groupings rather than

product lines, and they must do so in ways that result in substantial R&D costs being deducted from income to which the R&D is *not* factually related. In this case, the court of appeals' holding resulted in the reallocation of some $2 billion of petitioner Boeing's R&D costs, thereby increasing Boeing's tax liability by more than $400 million. This decision frustrates the Nation's trade policy by diluting a significant economic stimulus measure; it also expressly conflicts with a decision of another court of appeals and therefore leaves companies uncertain of the tax benefits they may obtain by expanding their export activities. Further review is plainly warranted.

1. In 1971, Congress enacted a set of provisions that were designed "to provide tax incentives for U.S. firms to increase their exports," a program that was thought important both for its "stimulative effect" and "to remove a * * * disadvantage of U.S. companies engaged in export activities." H.R. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971). See *Caterpillar Tractor Co.* v. *United States*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The "provisions were designed to neutralize some of the tax advantages for [European] exporters inherent in European territorial-type tax systems, which generally exempt all income earned outside the country from income tax and all exports from value-added and other consumption taxes." *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 116 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation).

Under the U.S. program, corporations were permitted to create special subsidiaries known as "Domestic International Sales Corporations" ("DISCs"). Income from export sales made through DISCs received partial tax deferral. IRC §§ 991-997.[1]

[1] In particular, a parent corporation could assign a portion of its otherwise taxable export income to its DISC subsidiary. The parent then was taxed only on the income it retained and a specified portion of the DISC's income. Tax was deferred on the DISC's remaining income either until it was distributed to the parent corporation or until the DISC ceased to meet statutory requirements (see IRC § 995(a), (b)). In 1984, Congress granted complete exemption from taxation to all DISC income that had not yet been taxed at that time. See Deficit Reduction Act of 1984, § 805(b)(2), Pub. L. No. 98-369, 98 Stat. 494.

As a consequence, "[t]he greater the DISC profit, the larger the amount of tax-deferred income * * * . Thus, a [corporation creating a DISC] had an incentive to *maximize* DISC profit." *St. Jude Medical, Inc.* v. *Commissioner of Internal Revenue*, 34 F.3d 1394, 1397 (8th Cir. 1994) (emphasis added).

In 1984, the DISC regime was replaced by one making use of Foreign Sales Corporation ("FSC") subsidiaries. See Deficit Reduction Act of 1984, §§ 801-805, Pub. L. No. 98-369, 98 Stat. 494. After the FSC regime, like the DISC regime, was declared to violate global trade rules, Congress responded by enacting the Extraterritorial Income Exclusion Act of 2000 ("ETI"). Each of the three regimes differs slightly from its predecessor, but none of the differences is relevant to the issues presented in this case. In each regime the mechanics of determining tax-favored income are substantially identical; in particular, each regime provides for grouping of income and deductions by product or product line.[2]

Under each of the three regimes, it is crucial to determine the income that is attributable to export sales and therefore qualifies for favorable tax treatment. The DISC statute "permitted a taxpayer to use one of three methods for determining the amount of deemed profit allocated to the DISC and its parent as a result of export sales. The taxpayer/parent

[2] The years at issue in this case involve the DISC and FSC provisions. Because the parties have agreed that there are no differences between DISC and FSC relevant to this case, for purposes of clarity we limit our discussion to DISC and refer to the Internal Revenue Code (26 U.S.C.) as in effect in 1979, unless otherwise indicated. The court below did this as well. See App., *infra*, 6a n.3.

could choose the method resulting in the greatest amount of profit [for the DISC]." *St. Jude Medical*, 34 F.3d at 1397. See IRC § 994; H.R. Rep. No. 533, *supra*, at 59 ("special pricing rules in the bill permit a DISC to earn a larger relative amount of the profit on sales by the DISC of its parent company's export products"). One of these methods, which was used by petitioner Boeing in this case, is known as the "combined taxable income" (or "CTI") method. IRC § 994(a)(2).

The DISC statute provides generally that, under the CTI method, a DISC is allocated a set portion of "the combined taxable income of [the] DISC and [its parent corporation] which is attributable to" export sales. IRC § 994(a)(2). The statutory language does not define "attributable to" or "combined taxable income" – and, in particular, does not explicitly address how expenditures are to be deducted from gross export receipts when calculating net export income. See *St. Jude Medical*, 34 F.3d at 1398. But that question is addressed in detail both by the legislative history of the DISC statute and by regulations prescribed by the Secretary of the Treasury pursuant to the statute.

The committee reports accompanying the DISC legislation contemplate that all expenses fall into one of two categories that receive differing treatment in the calculation of CTI. CTI is to be "determined by deducting from the DISC's gross receipts" [1] *all* "expenses * * * which are *directly related* to the production or sale of the export property and [2] *a portion* of the * * * *expenses not allocable to any specific item of income*, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the [parent corporation] and the DISC." H.R. Rep. No. 533, *supra*, at 74 (emphasis added). This directive was faithfully implemented by the DISC regulations, which define CTI as "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC * * * *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations then provide specific

guidance on how to conduct this calculation, explaining that costs

> which shall be treated as relating to gross receipts from sales of export property are (a) [those] *definitely related*, and therefore allocated and apportioned, thereto, and (b) a ratable part of other expenses * * * which are *not definitely related* to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

This cross-reference in the DISC regulations to Treas. Reg. § 1.861-8 also grew out of the statutory background and harked back to the legislative history of the DISC statute. The committee reports explain that combined taxable income is to be determined "generally in accordance with the principles applicable under [IRC] section 861," one of the statutory provisions that classify income as either U.S. or foreign source income for U.S. income tax purposes. H.R. Rep. No. 533, *supra*, at 74. As the DISC legislative history emphasizes, IRC § 861 includes rules for determining the net income from a given source by "generally allocat[ing] to each item of gross income all expenses directly related thereto, and then apportion[ing] other expenses among all items of gross income on a ratable basis." *Ibid.*[3] Treas. Reg. § 1.861-8, which is cited in the DISC cost allocation regulation, "provided specific guidance for applying the allocation and apportionment rules referred to in IRC §§ 861, 862, and 863." *St. Jude Medical*, 34 F.3d at 1398. At the time the DISC legislation was enacted, Treas. Reg. § 1.861-8 "reiterated [IRC] § 861(b)'s language." *Id.* at 1402. See Treas. Reg. § 1.861-8 (1957).

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[3] IRC § 861(a) identifies income that is United States source gross income. IRC § 861(b) provides for determining net, taxable U.S. source income by subtracting from gross income "the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income."

The DISC regulations also address a second issue that is relevant to the calculation of tax-deferred export income. In allocating and apportioning costs so that they may be deducted from revenue, the regulations provide that the determinations may be made either on a transaction-by-transaction basis or, "at the annual choice of the taxpayer[,] * * * on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). The taxpayer's choice of a product or product line for these purposes is conclusive so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). Thus, "[t]he taxpayer's choice [as to grouping] * * * shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv). Accordingly, when a taxpayer chooses to group its export sales by product, costs that definitely relate to each particular product group must be specifically allocated to that group, while costs that do not definitely relate to a particular product group must be apportioned among all relevant classes of income. Costs that relate to a particular product or product group *cannot* be allocated to any other product group, on a pro rata basis or otherwise.[4] These grouping procedures were contemplated by

[4] To illustrate, suppose that Megacorp, a U.S. conglomerate, makes and sells $100 worth of space shuttles, $100 worth of scooters, and $100 worth of pogo sticks during a particular year. All of the space shuttles are sold domestically to NASA, and all of the scooters and pogo sticks are exported through Megacorp's DISC. During the same year, Megacorp spends $30 to research fuel alternatives for its space shuttles, $10 to research scooter wheel technology, and nothing for pogo stick research. Megacorp also spends another $20 attempting to develop a new automobile that would recycle engine exhaust and $15 to research the impact of solar-generated neutrinos on the motion of all objects. Megacorp anticipates that its neutrino research might lead to improvements in any of its products or to entirely new products.

Congress. See H.R. Rep. No. 533, *supra*, at 74 ("Although * * * the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.").

2. The dispute now before the Court stems from a provision added to the IRC § 861 "sourcing" regulations in 1977, six years after enactment of the DISC statute and two years after issuance of the final DISC regulations in 1975. As a general matter, the 1977 revision of Treas. Reg. § 1.861-8 continued to "emphasize the factual relationship between the deduction and a class of gross income." Treas. Reg. § 1.861-8(b)(1). Revised Treas. Reg. § 1.861-8(e)(3), however, established a special rule for the allocation of research and development expenses, providing that such expenses "shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category * * * of the taxpayer" set forth in the Office of Management and Budget's Standard Industrial Classification ("SIC") Manual.[5] This regulation thus "deemed a definite relationship [to exist]

Under the DISC regulations, Megacorp can treat each of its four existing or nascent products as a separate group and calculate its total DISC income by adding up the separate net income (*i.e.*, CTI) attributable to its exported scooter and pogo stick groups. It does that by assigning its "definitely related" $10 of scooter R&D exclusively to its scooter group sales and apportioning its $15 of "indefinitely related" neutrino R&D in proportion to all of its current sales – $5 to scooters and $5 to pogo sticks (in each case, $15 x $100/$300). Megacorp's other R&D costs, for space shuttles and automobiles, are not relevant to the CTI calculations, because all of these costs "definitely relate" to existing or future products that Megacorp's DISC does not sell. Ignoring Megacorp's other costs, scooter CTI is thus $85 ($100 minus $10 minus $5), pogo stick CTI is $95 ($100 minus $5), and total CTI is $180.

[5] The provisions of Treas. Reg. § 1-861-8(e)(3) were renumbered in 1996 and, with amendments not relevant to this petition, were republished as Treas. Reg. § 1.861-17. See App., *infra*, 9a n.7.

between an expenditure for R&D and *all* income reasonably connected with a specific *broad product category*" (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D expense.[6]

3. For over 40 years, petitioner Boeing has been a world leader in commercial aircraft development and a major U.S. exporter of commercial aircraft. During the period at issue in this litigation, DISC-eligible export sales constituted approximately 70% of Boeing's commercial aircraft sales by dollar volume. Boeing exported commercial aircraft through a qualified export subsidiary. Before 1984, that subsidiary was Boeing International Sales Corporation, a qualified DISC; between 1984 and 1987, that subsidiary was Boeing Sales Corporation, a qualified FSC.

Boeing has maintained its leadership position by continuously developing new commercial aircraft. Consistent with industry practice, Boeing organizes its internal operations along product lines (*e.g.*, the 727, 737, and 757), each of which constitutes a separate "Program" within the Boeing organization. Management and staff for each Program are responsible for developing and managing a particular product line, including the line's various models and derivatives (for

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[6] Again consider Megacorp. Because all of Megacorp's diverse R&D pertains to products falling within SIC classification 37, which broadly covers all "transportation equipment," Treas. Reg. § 1.861-8(e)(3) would place the entirety of that R&D into a single pot and allocate the undifferentiated sum among all products in proportion to current sales. Thus, the exported scooters and pogo sticks each would attract $25 of R&D (total R&D of $75 x $100/$300), the CTI deemed attributable to each of those groups would be $75 ($100 minus $25), and total CTI would be $150 – in contrast to the $180 of total CTI that would result from applying the DISC regulations. This difference occurs because Treas. Reg. § 1.861-8(e)(3) mechanically reassigns to all products portions of all of Megacorp's R&D that in fact are "definitely related" to particular products.

example, passenger and cargo versions of the 747). App., *infra*, 16a.

As a leader in aviation technology, Boeing spends billions of dollars on research and development. Boeing allocates its R&D costs both *across* airplane Programs and directly *to* particular Programs, depending on the type of research. Some of Boeing's research is broad-based and aimed at advancing the state of the art for commercial aviation technology, including general avionics and aerodynamics research (such as wind tunnel tests to study wing airfoil designs and engineering analysis seeking ways to improve the weight and strength of airplanes). Boeing also conducts research to create and develop new products. Such research includes, for example, sketching and analyzing alternative fuselages, wings, and engines, as well as other technologies that could eventually be configured into a new commercial aircraft. Boeing refers to both of these types of general research and development as "Blue Sky R&D." App., *infra*, 2a-3a, 16a-17a.

In addition to this general R&D, Boeing engages in extensive R&D for each *particular* product line or type of aircraft that the company has decided to produce. Research and development to design, develop, test, and qualify the new aircraft for commercial service is a major component of each Program. For example, because each new aircraft has a unique configuration, Boeing engineers must specially design thousands of parts to fit the new aircraft's configuration and aerodynamic requirements. Similarly, Boeing must conduct extensive research and testing to ensure that a new aircraft will meet national and international safety standards. Research directly related to particular Programs constituted over 75% of Boeing's total R&D expenditures for the years at issue in this litigation. Boeing refers to the Program-specific research and development as "Program R&D" (or "Company Sponsored Product Development R&D"), because it is product-specific and generally not transferable to other Programs or aircraft. App., *infra*, 3a, 17a.

Mirroring its internal organizational structure, Boeing's accounting practices track costs and revenues along Program lines. Specifically, Boeing's cost accounting system allocates costs to the activity to which they are most closely related. Each airplane Program is a separate "final cost objective," and the accounting system allocates to each Program those costs directly related to it. The same is true for revenues. So, for example, the costs and sales of the 727 are accounted for separately from the 767, which are accounted for separately from the 777. In keeping with this framework, Boeing's cost accounting system allocates all research and development that is directly associated with a particular product line (the Program R&D) to that Program. However, costs for general research and development that are not directly related to a particular program (the Blue Sky R&D) are apportioned among Programs on a pro rata basis. For financial accounting and federal income tax purposes, Boeing deducts all research and development costs – including costs relating directly to a particular Program and those that must be apportioned among Programs – in the period in which they are incurred. This is true even if there are no corresponding sales in that period. App., *infra*, 3a, 17a-18a.

For DISC and FSC purposes, Boeing elected to treat each of its Programs as a separate product group, as permitted by Treas. Reg. § 1.994-1(c). Boeing used the CTI method to calculate the relevant income of each group. To determine CTI in each case, Boeing started with the product group's gross export receipts and subtracted from them the total combined costs of its export subsidiary and its United States operations that directly related to those export receipts, as well as a portion of its costs that did not directly relate to any Program. See App., *infra*, 3a, 17a. As part of this process, Boeing subtracted research and development costs from the revenues of each product group. Program R&D was attributed directly to the relevant Program; Blue Sky R&D was apportioned across Programs. *Id.* at 3a, 17a-18a.

4. After conducting an audit and reviewing Boeing's taxes for the years at issue (1979-1987), the IRS disallowed Boeing's method of allocating and apportioning its R&D costs and reallocated those expenses pursuant to Treas. Reg. § 1.861-8(e)(3). As noted above, that provision deems *all* of Boeing's R&D in any given year to be related to sales of *all* airplane models in that year, because all of Boeing's various commercial aircraft product lines fall into the single SIC Code 37 (transportation equipment). The IRS treated all R&D costs the same, without regard to their factual relationship to a particular product line. For example, the IRS allocated portions of the Program R&D costs that were attributable solely to aircraft still in the developmental stages (as were the 757 and 767 during some of the years at issue) to export sales generated by other Programs under which aircraft were actually in production and being sold during the years in question (such as the 747). The IRS apportioned costs in this manner even though the R&D expenditures associated with developing a new product line (such as the 767), obtaining FAA certification, and bringing it to market do not in any way contribute to the development of existing product lines (such as the 747). By reallocating $2 billion of research and development costs related to specific Boeing Programs and charging them against the revenues from other Programs, the IRS decreased the CTI upon which Boeing's export tax benefits were based and thereby increased Boeing's overall tax obligation for the years 1979 to 1987 by some $ 419 million. App., *infra*, 3a-4a, 18a.

Boeing paid the additional tax demanded by the IRS and filed suit seeking a refund. The district court ruled for Boeing, relying heavily on the Eighth Circuit's decision in *St. Jude Medical* and holding that Treas. Reg. § 1.861-8(e)(3) is invalid as applied to CTI computations. App., *infra*, 15a-24a. The district court pointed to three considerations supporting this conclusion. First, the court explained that, by mandating that export sales be grouped according to the broad SIC classifications, Treas. Reg. § 1.861-8(e)(3) conflicts with Treas.

Reg. §§ 1.994-1(c)(6)(iv) and (7), which provide that taxpayers may group income and allocate costs by product or product line. App., *infra*, 21a-22a. Second, the court reasoned that Treas. Reg. § 1.861-8(e)(3) creates an artificial "deemed" relationship between sales and R&D that conflicts with Congress's intent to "'generally allocate to each item of gross income all expenses *directly related thereto.*'" App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)) (emphasis in *St. Jude Medical*). And third, the court determined that Congress intended DISCs to deduct only those costs "'directly related to the production or sale of the export property'"; charging unsuccessful R&D that is never actualized as a successful product to current export sales of successful products through an artificial "deemed" relationship is "inconsistent" with that expressed intent. App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)). The district court thus concluded that the IRS erred in applying Treas. Reg. § 1.861-8(e)(3) to Boeing's CTI calculation, holding that Boeing was entitled to group its export sales by product line and allocate research and development expenditures accordingly.

On appeal, the Ninth Circuit reversed. App., *infra*, 1a-14a. The court of appeals opined that Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c)(7) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3)." App., *infra*, 12a. The Ninth Circuit also suggested that application of Treas. Reg. § 1.861-8(e)(3) in this context is supportable because, at the time of the enactment of the DISC statute, "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. The court therefore held that,

as applied in this case, "Treas. Reg. § 1.861-8(e)(3) * * * is a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a. In reaching this conclusion, the Ninth Circuit expressly "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

REASONS FOR GRANTING THE PETITION

The decision below creates an express conflict with the holding of the Eighth Circuit on an important and recurring issue of federal law. This conflict plainly warrants the Court's attention. The existence of contrasting standards governing the treatment of R&D expenses in different circuits results in identically situated taxpayers being treated differently on the basis of geography; will generate a substantial volume of litigation; and creates considerable confusion in the operation of a tax incentive statute, an area where predictability and certainty are essential. The issue, moreover, is one of enormous practical importance: this case alone involves more than $400 million in tax liability, with billions of dollars potentially at stake across the Nation. Finally, the Ninth Circuit's decision frustrates the manifest intent underlying the DISC and related tax regimes, which Congress established to effectuate a vital international trade policy. Review by this Court therefore is imperative.

A. There Is An Express Conflict In The Circuits On Whether Treas. Reg. § 1.861-8(e)(3) May Be Applied To The Computation Of CTI

Review by this Court is necessary because there is a clear and irreconcilable conflict in the courts of appeals on a significant issue of federal law. The conflict is indisputable: the Ninth Circuit expressly, and candidly, "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

On this point, the Ninth Circuit was correct: *St. Jude Medical* is indistinguishable from this case. In *St. Jude Medical*, as here, the taxpayer produced a number of devices

that were stipulated to be "separate products or product lines under recognized industry or trade usage." *St. Jude Medical*, 34 F.3d at 1401. In that case, as in this one, these separate products all fell into a single SIC classification. See *ibid.* In *St. Jude Medical*, as here, the taxpayer separately allocated R&D costs to each of the products with which they were actually associated, instead of apportioning them generally across the SIC category. See *id.* at 1396, 1400. And in that case, as in this one, the IRS disapproved the taxpayer's allocation of the R&D, contending that, under Treas. Reg. § 1.861-8(e)(3), *all* of the R&D costs relating to *all* products within the SIC classification had to be spread across the export receipts from *all* products within the classification. *Id.* at 1396, 1400.

The outcome in *St. Jude Medical*, however, was quite different from the one here. The Eighth Circuit rejected the IRS's position, "hold[ing] that § 1.861-8(e)(3) is invalid as applied to DISC CTI computations." 34 F.3d at 1396. The court reasoned that "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." *Id.* at 1401. Moreover, the Eighth Circuit found that "the deemed relationship mandated by § 1.861-8(e)(3)(i) is inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related* thereto.'" *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74 (emphasis added by the court)). And the court noted that mandatory use of the SIC categories, which had the effect of requiring that income from successful R&D "'bear the cost of unsuccessful research and development'" (*ibid.* (quoting Treas. Reg. § 1.861-8(e)(3)(i)), would be "inconsistent with Congress's stated intent" to deduct from DISC gross receipts those expenses that "'are directly related to the production or sale of * * * property.'" *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74).

In reaching that conclusion, the Eighth Circuit acknowledged "a conflict between two Treasury regulations:

§ 1.994-1 and § 1.861-8. Section 1.994-1 allows the taxpayer's choice regarding the manner of grouping transactions to control. Section 1.861-8 mandates a specific method of grouping transactions." *St. Jude Medical*, 34 F.3d at 1402. In resolving this conflict, the court looked to the principles generally applicable under IRC § 861, concluding:

> An examination of § 861(b)'s language does not allow us to infer that Congress intended to impose mandatory SIC transaction grouping in CTI computations related to R & D expenditures. * * * In fact, § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language.

St. Jude Medical, 34 F.3d at 1402 (footnote omitted). After examining "the origin and the purpose of the DISC statute," the Eighth Circuit accordingly held "that § 1.861-8 is unreasonable, and thus invalid, as applied to DISC CTI computations. * * * We believe Congress intended in CTI computations to allocate costs, such as R & D expenditures, to definitely related gross export receipts." *Ibid.*

In this case, the Ninth Circuit reached precisely the opposite conclusion. The Ninth Circuit expressly recognized the Eighth Circuit's holding "that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC CTI computations" and "did not control the computation of DISC combined taxable income." App., *infra*, 10a. As we have explained, however, the Ninth Circuit went on to reject the Eighth Circuit's analysis. See *ibid.* The court below reasoned, instead, that "[the] statutory text does *not* confine the relevant costs to those 'definitely related' to sales of a particular product" (*id.* at 11a (emphasis added)); that "[t]here is *no* conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)" (*id.* at 12a (emphasis added)); and that Treas. Reg. § 1.861-8(e))(3) "*is* a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a (emphasis added).

The Ninth Circuit made no attempt to, and plainly could not, reconcile its holding with that of the Eighth Circuit in *St. Jude Medical*. Deciding cases that in all relevant respects are identical, the Eighth Circuit held that taxpayers are entitled to allocate R&D expenses on the basis of the specific product or product-line groupings that the DISC regulations authorize, while the Ninth Circuit held that same treatment impermissible, concluding that taxpayers instead must apportion R&D expenses on the basis of broad SIC classifications. As a result, identically situated taxpayers located in different parts of the country must bear dramatically different tax burdens. Because of the great need for "uniform application of the Internal Revenue laws" (*Turnbow* v. *Commissioner*, 368 U.S. 337, 339 (1961)), this intolerable situation warrants review by this Court.

B. The Decision Below Is Wrong

The need for review is particularly acute because the decision below is plainly wrong. The background and contemporaneous understanding of the DISC statute unmistakably establish two fundamental principles: (a) expenses that are *directly* related to a particular class of gross income must be allocated to that class and no other; and (b) taxpayers are entitled to select the grouping of products or product categories that they believe to be most advantageous. The court of appeals' decision departs from both of those principles. It thus frustrates the congressional intent and undermines the purposes of a significant federal tax incentive.

1. There is no denying that the Ninth Circuit's approach leads to perverse results. Under the court of appeals' holding, Boeing's R&D that relates exclusively to *one* specific airplane model has to be allocated, in large part, to revenue from the sale of *other*, unrelated models. Thus, if Boeing incurred a research expense in 1987 that was directed solely to improving a component unique to a new 767 model that was not yet in production, the Ninth Circuit would require treating the expense as part of the cost of that year's 747 sales – even

though *that* model of aircraft had been introduced years earlier and did not benefit at all from the R&D relating to 767s. Indeed, the court of appeals' holding would require that research expenses incurred in the development of *scooters or boats* be allocated, in part, to the production of *aircraft or space vehicles* because they all fall within the SIC Code (37) for "transportation equipment."

When it enacted the DISC statute, Congress certainly did not contemplate requiring such an outcome. To the contrary, the DISC regime was premised on the understanding that the income "attributable to" export sales under IRC § 994 would be calculated by allocating expenses to the class of income with which they are factually associated. The statute was enacted against the background of IRC § 861(b), which defines taxable income as gross income less [1] "the expenses * * * properly apportioned or allocated thereto and [2] a ratable part of any expenses * * * which cannot definitely be allocated to some item or class of gross income." Plainly, this scheme postulates that, if an expense *can* "definitely be allocated to some item or class of gross income," it falls into the first of these categories and therefore may *not* be ratably apportioned across all classes of income.

The legislative history of the DISC statute makes this point explicit, taking pains to spell out precisely the expense allocation scheme that Congress intended. The committee reports expressed Congress's intent that expense allocations under DISC "be determined generally in accordance with the principles applicable under section 861," observing that those IRC § 861 rules "generally allocate to each item of gross income all expenses directly related thereto." H.R. Rep. No. 533, *supra*, at 74. Applying this principle in the DISC context, the committee reports went on to declare that CTI is to be computed by subtracting from export revenue those "expenses * * * which were *directly related* to the production or sale of the export property and a portion of the * * * expenses *not allocable to any specific item of income*." *Ibid.* (emphasis

added). This system leaves no room for taking a portion of the expenses that *are* in fact related to particular export property and apportioning them to *other*, unrelated property.[7]

This understanding is confirmed by the DISC regulations that were promulgated almost contemporaneously with the enactment of the DISC statute. These rules identify the costs that "shall be treated as relating to gross receipts from sales of export property" as including both expenses that are "*definitely related*, and therefore allocated and apportioned, thereto," and "a ratable part of other expenses * * * which are *not definitely related to a class of gross income*." Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added). Again, this structure plainly contemplates that costs that *are* definitely related to particular products may not be allocated or apportioned to *other* products.

Moreover, at the time these regulations were promulgated it was clearly understood that a factual relationship had to exist between R&D expenditures and any "definitely related" income-producing activity to which those expenditures might be exclusively allocated. The final DISC allocation and apportionment regulation issued in 1975, Treas. Reg. § 1.994-1(c)(6)(iii), provides that these determinations are to be made "in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." As we have explained (at page 5, *supra*), the

[7] Aside from Treas. Reg. § 1.861-8(e)(3), the aberrational R&D regulation at issue here, Treasury regulations have themselves consistently recognized that the IRC § 861 regime contemplates a factual relationship between an expense and the class of income to which it is allocated. Treas. Reg. § 1.861-8(b) specifically notes that the allocation "rules emphasize the factual relationship between the deduction and a class of gross income." Indeed, the preamble accompanying the proposal of the Section 861 regulations on which the government relies in this case states: "If a proper allocation and apportionment of deductions *on the basis of factual relationships* is not accomplished, taxable income attributable to various sources will not be properly reflected under the applicable operative provisions of the Code." 41 Fed. Reg. 49,161 (Nov. 8, 1976) (emphasis added).

version of § 1.861-8 contemporaneously in force simply reiterated IRC § 861(b)'s language, distinguishing between expenses that can and cannot "definitely be allocated" to a class of income. And the proposed § 1.861-8 regulations in place in 1975 unambiguously applied the factual relationship principle to R&D in the DISC context. Those proposed regulations set forth the general rule as follows:

> Expenditures for research and development which a taxpayer deducts * * * shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class.

Prop. Treas. Reg. § 1.861-8(e)(3)(i) (1973). Example (1) in this proposed regulation illustrated the rule by treating four-, six-, and eight-cylinder gasoline engines as *separate* products, each with separate and directly allocable R&D. Example (2) extended this tracing of R&D to a DISC CTI computation in which four- and six-cylinder engines were grouped separately.[8]

Against this background, the Ninth Circuit plainly erred in holding that Treas. Reg. § 1.861-8(e)(3) could validly be applied in the circumstances of this case. That regulation irrebuttably deems *all* R&D expenses to be definitely related to *all* income within a broad SIC Code, so that the expenses must be spread over *all* products and product groups falling within that Code. This "deemed" relationship ignores the actual

[8] The Secretary of the Treasury evidently relied on these examples when including the reference to Treas. Reg. § 1.861-8 in the DISC regulations. The Technical Memorandum accompanying the final DISC regulations indicated that they did not include their own examples "for determining the portion of certain expenses of the [parent corporation] to be deducted in determining combined taxable income of the DISC and [the parent corporation]" because the drafters anticipated that the examples in the 1973 proposed § 1.861-8 regulations would apply. 1974 TM Lexis 30, at *20 (Oct. 29, 1974).

relationship between expense and income that Congress explicitly intended to govern CTI calculations under the DISC statute. The rule established by § 1.861-8(e)(3) also is contrary to the undisputed facts in this case, which establish that the research at issue here related to the design of *particular* airplane lines; it implements a regime in which narrowly focused research relating to the details of a new airplane is treated as a cost of selling an airplane that has been in production for 20 years; and it perverts the DISC scheme's central purpose by reducing the incentives that encourage exports. For these reasons, as the Eighth Circuit correctly held, "§1.861-8[(e)(3)] is unreasonable, and thus invalid, as applied to DISC CTI computations." *St. Jude Medical*, 34 F.3d at 1402.

2. The Ninth Circuit's holding that CTI must be calculated by apportioning expenses across all products within a broad SIC Code also is insupportable for a second, closely related reason: the DISC regulations emphatically state that the taxpayer is entitled to *choose* whether or not CTI determinations will be made on a product-by-product basis. The taxpayer is entitled to make this choice annually (see Treas. Reg. §1.994-1(c)(7)(i)) and its "choice [as to grouping] * * * shall be *controlling*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). Indeed, the regulations specifically provide that the taxpayer's choice "will be accepted by [the IRS]" so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). The DISC regulation, moreover, makes clear that the taxpayer's choice in this regard will determine the category of income to which expenses should be allocated in computing CTI: "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year *resulting from such grouping*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). This grouping rule was sufficiently important that Congress expressly incorporated it into both the FSC and ETI

statutes that succeeded DISC. IRC § 927(d)(2)(B) (1984); IRC § 943(b)(1)(B) (2000).

The Ninth Circuit's approach is flatly at odds with this principle. Rather than allocate costs to the classes of income "resulting from [the taxpayer's] grouping," as the DISC regulation mandates, the court of appeals requires that costs be allocated according to SIC Code. As the Eighth Circuit explained, "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated [either] on a product-by-product basis or on the basis of product lines." *St. Jude Medical*, 34 F.3d at 1401. Indeed, "[Treas. Reg.] § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language." 34 F.3d at 1402. The decision below thus works a significant, and unwarranted, change in the incentives provided by the DISC statute and regulations.

The DISC provisions were specifically designed to encourage manufacturers to locate their productive facilities in the United States and to export their goods, rather than to supply their foreign markets from overseas factories. See H.R. Rep. No. 533, *supra*, at 58; S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). To accomplish that result, Congress offered relief from taxation for a portion of the manufacturer's income "attributable to" (IRC § 994(a)(2)) sales of the exported goods. But by attributing millions of dollars of R&D expenses to export sales, even though the expenses in fact bore no relationship to those sales, the decision below artificially understates Boeing's true export sales income and reduces the incentive of U.S. companies to expand their domestic manufacturing operations. By contrast, the Eighth Circuit understood that this approach "may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules." 34 F.2d at 1402-1403.

3. The rationales advanced by the Ninth Circuit cannot support its holding. *First*, the court of appeals opined that Treas. Reg. § 1.861-8(e)(3) and § 1.994-1(c) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income." App., *infra*, 12a. This perplexing statement disregards *both* the controlling facts and the controlling law. The statement is flatly wrong as a factual matter, because it is undisputed that the R&D costs for each Boeing Program were *definitely* related to that Program and that Program alone, and were completely unrelated – "indefinitely" or otherwise – to other Programs. The Ninth Circuit's statement is equally indefensible as a legal proposition, because Treas. Reg. § 1.861-8(e)(3)(i) manifestly did *not* transform any R&D expenses into costs "'indefinitely' related to specific items of income." Instead, the regulation explicitly deems all R&D costs to be "*definitely* related to all income reasonably connected with the relevant [SIC] category" (emphasis added). Either way, the Ninth Circuit's purported "harmonization" of the regulations was nothing but rhetorical alchemy.

Second, the court of appeals may have meant to adopt the government's suggestion (see U.S. 9th Cir. Br. 11) that it was impermissible for Boeing to allocate R&D expenses to Programs that had no current gross income from which those expenses could be deducted. See App., *infra*, 3a (stating that such costs "simply 'disappeared'"). If so, the court plainly was incorrect. There is nothing inherently wrong in having the costs directly related to a particular product line exceed the gross income generated by that line in a given year. To the contrary, Treas. Reg. § 1.861-8(d) explicitly states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [which emphasizes the "factual relationship between the deduction and a class of gross income"] even though, for the taxable year, *no gross income in*

such class is received" (emphasis added). Indeed, this principle was recognized even by the R&D allocation regulation itself. See Treas. Reg. § 1.861-8(e)(3)(ii)(B) ("[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping."). See also IRC § 174 (general R&D incentive provision that allows R&D to be deducted in current year even though it may not generate income until future years); Treas. Reg. § 1.861-8(c)(1) ("In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping").

Third, the court of appeals found it significant that "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. But that observation, while doubtless correct, is simply beside the point. That certain costs (*i.e.*, overhead) are not directly related to specific products hardly means that the costs that *are* directly related to specific products should be apportioned to *other* products. The Ninth Circuit's sleight-of-hand thus cannot obscure its departure from the fundamental principles underlying the DISC statute and regulations.

C. The Issue Presented Here Is A Recurring One Of Great Practical Importance

The question presented in this case has enormous practical significance. The Ninth Circuit's decision severely undermines the efficacy of an important export tax incentive program that has been used for decades by thousands of major U.S. manufacturers.

In its most recent (year 2000) analysis, the IRS reported that the number of FSC returns had risen to well over 4,000 in 1996, a 42% increase over the 3,073 FSC returns just filed four years

earlier.[9] Not only is the number of these taxpayers on the rise, but the amount of tax benefits is increasing as well. These companies' aggregate annual FSC tax benefits were estimated in February 2000 at approximately $4 billion for the year 2000, with a projected increase to $5.5 billion by the year 2005.[10] Estimates of total annual tax benefits from ETI, which replaced the FSC regime, begin at $4.8 billion for 2003, with the number projected to rise to $6.5 billion by the year 2007.[11]

Nearly 90% of all FSC returns filed for 1996 reported manufactured product exports, with nearly two-thirds of these revenues coming from exports of non-electrical machinery; transportation equipment; electrical machinery, equipment, and supplies; and chemicals and allied products.[12] Thus, thousands of FSCs are in industries with significant R&D expenditures, and the method of allocation of those expenditures can have a substantial effect on the amount of their tax-based export incentive. The resolution of the issue in this case will significantly affect many U.S. exporters that made substantial R&D expenditures during the years for which the FSC regime was in effect; as evidenced by the $419 million at issue in this case, the amounts at stake for any given taxpayer with regard to the R&D allocation issue can be very large. Equally

[9] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

[10] Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2001, Table 32-4, Tax Expenditures by Function for Fiscal Years 1999-2005, February 7, 2000.

[11] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006, JCS-1-02, January 17, 2002.

[12] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

important, resolution of the issue will affect the behavior of thousands of taxpayers that must decide both whether to make substantial R&D expenditures on exports under the ETI regime and whether the tax incentives are sufficient to warrant an increase in exports.

Congress has long evidenced a concern for the competitiveness of the U.S. economy in the world market and has consistently sought to improve the U.S. balance of payments. Three decades ago, Congress determined that strong export incentives would promote those goals. In enacting the DISC provisions in 1971, Congress deviated from the general residence-based tax system of the U.S. (*i.e.*, taxing U.S. taxpayers on their worldwide income) and adopted a feature of territorial taxation (taxing only income earned in the U.S. and exempting or deferring some income of U.S. taxpayers earned abroad) that was designed to tax export sales more favorably than comparable domestic transactions.[13] These provisions, intended to level the playing field for U.S. exporters and to increase the volume of exports from the U.S., gave taxpayers considerable flexibility to maximize their tax benefits. It was no accident that the statutory scheme permitted taxpayers to

[13] See General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. See also *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 117 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation) ("Congress enacted both the DISC and the FSC in part to begin leveling the playing field between the U.S. income tax system * * * and more export friendly territorial systems. The FSC is not a provision designed to confer a tax benefit on U.S. exporters that is not enjoyed by their competitors abroad; to the contrary, the FSC is designed to ameliorate – in quite small measure – a significant tax advantage that is enjoyed by companies exporting from countries with territorial tax systems.").

allocate their expenses, including R&D expenses, to product groups.

Congress has steadfastly adhered to this important policy in the face of repeated protests from other countries that these features of U.S. law provide illegal export subsidies. Thus, as noted above (see pages 2-3, *supra*), after the DISC regime was determined to violate international law, Congress enacted the FSC legislation. In that legislation, Congress pointedly codified the principles of the DISC regulations that permit taxpayers to maximize their tax incentive through the allocation of expenses to product groups. The ETI legislation, which was enacted in November 2000 after the FSC regime also was declared inconsistent with international obligations, includes an identical provision.[14] The FSC regulations remain in effect under the ETI regime to fill the gap before new regulations are promulgated.[15]

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[14] The statutory product grouping provisions for FSC (IRC § 927(d)(2)(B)) and ETI (IRC § 943(b)(1)(B)) both state as follows:

> Grouping of transactions. To the extent provided in regulations, any provision of this subpart [the overall FSC or ETI regime] which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

[15] General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. The importance of the issue presented here is not diminished by the recent decision of the World Trade Organization's Appellate Body that the current ETI regime is inconsistent with WTO rules, which authorizes the European Union to impose retaliatory tariffs against the United States. See WTO Report of the Appellate Body on Complaint of the European Communities Concerning United States Tax Treatment for "Foreign Sales Corporations," Daily Rep. for Executives, No. 10, at L-1 (Jan. 15, 2002). That decision does not displace U.S. law and the ETI system thus remains in effect. The

At bottom, the decision below ignores Congress' continuous support for the grouping rule and undermines a longstanding statutory policy designed to provide tax incentives for exports. Prior to the Ninth Circuit's decision, taxpayers could rely on statutory and regulatory language, the intent of Congress, and the Eighth Circuit's validation of that understanding in *St. Jude Medical* to compute export income in accordance with the DISC/FSC/ETI regulations, including the grouping rule. After the Ninth Circuit's decision, however, that benefit is available with certainty only to taxpayers in the Eighth Circuit. Thousands of taxpayers in other circuits will not be able to predict the magnitude of the export incentives promised to them by ETI (or its successor regime). Nor will those taxpayers be able to take advantage of those incentives as Congress intended without significant risk of an IRS challenge. Moreover, taxpayers outside the Eighth Circuit are now vulnerable to IRS claims for back taxes that would retroactively reduce the incentives upon which those taxpayers already have relied. The Court should resolve this dispute so that a single rule applies to export decision-making and tax liability throughout the United States.

WTO decision may be accessed at <www.wto.org/english/tratop_e/dispu_e/distabase_wto_members4_3.htm>.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 2002

APPENDIX

APPENDIX A

Nos. 99-35818 and 99-35857

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THE BOEING COMPANY, and Consolidated Subsidiaries; BOEING SALES CORPORATION,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

THE BOEING COMPANY, and Consolidated Subsidiaries, Plaintiff, and BOEING SALES CORPORATION,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

April 4, 2001, Argued and Submitted,
Seattle, Washington
August 2, 2001, Filed

Before DAVID R. THOMPSON, TROTT, and PAEZ, Circuit Judges.

DAVID R. THOMPSON, Circuit Judge:

The United States appeals the district court's summary judgment determining that the Boeing Company and its consolidated subsidiaries ("Boeing") are entitled to an income tax refund of approximately $419 million for the years 1979 through 1987. The issue is how research and development costs ("R&D") should be accounted for computing Boeing's net

income from export sales of commercial airplanes under the Internal Revenue Code's export incentive provisions for a Domestic International Sales Corporation ("DISC") and a Foreign Sales Corporation ("FSC").

We have jurisdiction under 28 U.S.C. § 1291 (1994). We conclude that, in computing Boeing's net income, the Commissioner of Internal Revenue properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales. Accordingly, we reverse the district court's summary judgment granting Boeing's tax refund claim.[1]

FACTS

From 1972 to 1984, Boeing exported commercial airplanes through its subsidiary, Boeing International Sales Corporation, which qualified as a DISC under Internal Revenue Code ("I.R.C.") § 992. After 1984, Boeing exported commercial airplanes through its subsidiary, Boeing Sales Corporation, which qualified as a FSC under I.R.C. § 922.

During the relevant period, Boeing maintained separate "programs" for each of its major commercial airplane product lines.[2] Each of Boeing's programs constitutes a separate product or product line under industry practice and trade usage in the commercial airplane business.

In developing these programs, Boeing segregated its R&D costs into two broad categories. The first category, Blue-Sky R&D, was for R&D costs incurred prior to Boeing's Board of

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[1] In view of our reversal of the summary judgment for approximately $419 million in favor of Boeing, we also reverse the district court's partial summary judgment for approximately $1 million in favor of the United States, pursuant to Boeing's conditional cross-appeal which the government does not oppose.

[2] During the tax years at issue, Boeing established or maintained a separate program for the following airplane models — 707, 727, 737, 737-300, 747, 757 and 767.

Directors giving approval for a new airplane model, which approval was referred to as "Program Go Ahead." Blue Sky R&D included basic research relating to commercial airplanes that might be the precursor to a specific program. The second category, Company Sponsored Product Development, was for costs incurred for a specific program after Program Go Ahead had been given for a particular airplane model and included the R&D cost of designing, developing, testing and qualifying that airplane. Approximately 77 percent of the R&D costs in the tax years at issue in this case fall within the Company Sponsored Product Development category.

For accounting purposes, Boeing apportioned Blue Sky R&D to all of its airplane programs, but allocated Company Sponsored Product Development R&D directly to the particular program for which those costs were incurred. Boeing deducted all R&D costs in the period in which they were incurred, regardless of whether there were any corresponding sales during that period. This meant that significant R&D costs for any new program could be allocated to that program in years prior to any sales of airplanes within that program.

Boeing used the combined taxable income method ("CTI") to calculate the intercompany price and profits from its export sales. See I.R.C. §§ 994(a)(2) & 925(a)(2). Pursuant to Treas. Reg. § 1.994-1(c)(7), Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred. If those R&D costs exceeded the amount of sales for the airplane program to which those costs were allocated, the excess of costs over sales, according to the IRS, simply "disappeared," in that those costs were not accounted for by Boeing in computing its CTI.

During an audit, the IRS determined that Boeing's method of allocating its R&D costs to its DISC and FSC sales violated Treas. Reg. § 1.861-8(e)(3), which requires all R&D costs to be allocated to and apportioned among all sales within the broad

product categories set forth in the Office of Management and Budget's Standard Industrial Classification ("SIC"). Because all of Boeing's commercial airplane sales fell within SIC code 37 (Transportation Equipment), the IRS allocated all of Boeing's R&D costs in a given period to all of Boeing's commercial airplane sales in that period. By this method of allocation, none of the R&D expenses "disappeared" (the government's characterization); instead, all of such expenses were charged to sales in the relevant period.

This method of allocation by the IRS caused a substantial decrease in Boeing's net income from its DISC and FSC sales. Because net income from such sales is accorded favorable tax treatment, Boeing's overall income tax liability, according to the IRS, was substantially understated.

Boeing paid the amount of additional tax required by the IRS, and timely filed claims for refund. When those claims were denied or not acted upon, Boeing filed this suit seeking a refund of corporate income taxes and interest in the total amount of $458,609,373. Both sides moved for summary judgment. The district court, relying on *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (8th Cir. 1994), accepted Boeing's method of allocating R&D, and granted judgment in favor of Boeing for $419,110,539. This appeal followed.

ANALYSIS

We review de novo a district court's interpretation of the I.R.C. and corresponding treasury regulations. See *United States* v. *Hagberg*, 207 F.3d 569, 571 (9th Cir. 2000).

Generally, a court must defer to the Commissioner's interpretation of the I.R.C. by the regulations he issues, so long as those regulations "implement the congressional mandate in some reasonable manner." See *Redlark* v. *Commissioner*, 141 F.3d 936, 939 (9th Cir. 1998) (quoting *Rowan Cos.* v. *United States*, 452 U.S. 247, 252, 68 L. Ed. 2d 814, 101 S. Ct. 2288 (1981)). A court has authority to reject the Commissioner's

reasoned interpretation and invalidate a regulation only when the I.R.C. section to which the regulation applies has a meaning that is clear, unambiguous, and in conflict with the regulation. See *id.* (citing *Chevron U.S.A., Inc.* v. *Natural Res. Def. Council*, 467 U.S. 837, 841-44, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984)).

When Congress, by explicitly leaving a gap for an agency to fill, delegates authority to the agency to elucidate a specific provision of a statute by regulation, that delegation is "express" and the agency's regulations issued pursuant to the legislation are "legislative regulations." Such regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. See 141 F.3d at 939-40 (citing *Chevron U.S.A., Inc.*, 467 U.S. at 843-44). If delegation to the agency is implicit, however, a court owes deference only to the agency's reasonable interpretation of the statutory provisions and related regulations. See *McLean* v. *Crabtree*, 173 F.3d 1176, 1181 (9th Cir. 1999), cert. denied, 528 U.S. 1086, 145 L. Ed. 2d 685, 120 S. Ct. 814 (2000).

Both Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c) are legislative regulations because they were promulgated pursuant to I.R.C. §§ 863(a) and 994(b), which contain explicit grants of authority from Congress. See *Black & Decker Corp.* v. *Commissioner*, 986 F.2d 60, 63 (4th Cir. 1993) (explaining that section 863(a) provides express Congressional authorization for Treas. Reg. § 1.861-8, which describes the allocation of costs, losses, and deductions derived from domestic and foreign sources); see also I.R.C. § 994(b)(2) (granting the Secretary the authority to prescribe regulations "for the allocation of expenditures in computing combined taxable income. . . in those cases where a DISC is seeking to establish or maintain a market for export property").

In *St. Jude Medical*, however, the Eighth Circuit concluded that § 1.861-8(a)(3) was promulgated pursuant to the Commissioner's general grant of authority in I.R. C. § 7805(a),

not pursuant to any express legislative delegation, and as a result the court owed deference only to the IRS's reasonable interpretation of the applicable statutes and regulations. See *St. Jude Medical*, 34 F.3d at 1400 n. 11.

In the present case, we need not decide which standard of review applies, because whether we review the Commissioner's interpretation under an "arbitrary or capricious" standard, or under the arguably less deferential "reasonableness" standard, we uphold that interpretation. We agree with the Commissioner that Boeing's method of allocating R&D costs and calculating CTI on its DISC and FSC sales of commercial airplanes violates Treas. Reg. § 1.861-8(e)(3)'s requirement for the allocation of "total costs" and that Treas. Reg. § 1.861-8(e)(3) is a permissible interpretation of the I.R.C.

The DISC and FSC provisions permit a taxpayer to defer or exempt from tax a significant portion of income from export sales. See I.R.C. §§ 991-997; §§ 921-927.[3] These tax incentives are intended to encourage and increase exports by domestic corporations.

Qualified DISCs, which are subsidiaries incorporated under "the laws of any State," are not taxed directly.[4] I.R.C. § 992(a)(1). Instead, the parent corporation is taxed on a

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[3] The DISC provisions were enacted in 1971. The FSC provisions were enacted in 1984 to cure some problems with the DISC provisions. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. Because the differences between these statutory schemes are not relevant to this appeal, we generally discuss only the DISC provisions.

[4] Prior to the enactment of the DISC legislation, domestic corporations which directly marketed their products in a foreign market were taxed on their foreign earnings "at the full U.S. corporate income tax rate regardless of whether [the] earnings [were] kept abroad or repatriated." H.R. Rep. No. 92-533, reprinted in 1971 U.S.C.C.A.N. 1825, 1872.

specified portion of its subsidiary DISC's profits. See I.R.C. § 995. The DISC's remaining profits are tax deferred until either they are distributed to the parent corporation or the DISC ceases to meet statutory requirements. See I.R.C. § 995(a) & (b).[5]

The amount of a DISC's profit depends on the transfer price at which its parent is deemed to have sold to it the product it resells. There are three methods for calculating this transfer price, and thus the amount of taxable income made on export sales. See I.R.C. § 994(a). These "intercompany pricing rules" are intended to "avoid the complexities of the [arm's-length] pricing rules . . . and also to provide encouragement for the operation of DISC's." H.R. Rep. No. 92-533, *reprinted* in 1971 U.S.C.C.A.N. 1825, 1887. Although the intercompany pricing rules permit a DISC to earn profits in excess of the arm's length pricing rules, they also serve to limit the amount of income which can be deferred from taxation. See *id.*; *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995).

A taxpayer is permitted to choose the pricing method that maximizes its DISC's profit. See I.R. C. § 994. There is an incentive to maximize DISC profit because "[t] he greater the DISC profit, the larger the amount of tax-deferred income and the larger the deemed dividend." *St. Jude Medical*, 34 F.3d at 1397. Deemed dividends are taxed as foreign source income, which qualifies the parent corporation for a corresponding foreign tax credit. See I.R.C. §§ 862(a)(2), 901 & 904.

In computing its DISC profits, Boeing chose the combined taxable income (CTI) method described in I.R.C. § 994(a)(2), which permits such profits to be computed on the basis of fifty percent of the "combined taxable income . . . attributable to the qualified export receipts . . . ." The statute does not define

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[5] In contrast. a portion of a FSC's profits are permanently exempt from taxation. See I.R.C. § 923(a).

"combined taxable income." Instead, "combined taxable income" is defined in Treas. Reg. § 1.994-1(c)(6), which states:

> [T]he combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier *which relate* to such gross receipts.

26 C.F.R. § 1.994-1(c)(6) (emphasis added). Gross receipts are "the total receipts from the sale ... of property held primarily for sale ... in the ordinary course of trade or business, and gross income from all other sources," but do not include interest with respect to the sales. 26 U.S.C. § 993(f); 26 C.F.R. § 1.994-1(c)(6).

Generally, the pricing of goods sold by a supplier (the taxpayer) to its DISC should be made on a transaction-by-transaction basis. *Id.* § 1.994-1(c)(7). However, the taxpayer may elect to determine the price "on the basis of groups consisting of products or product lines." *Id.* The taxpayer's choice as to the grouping of transactions "shall be controlling," and "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." *Id.* § 1.994-1(c)(6)(iv). The district director must accept this determination if it conforms to a recognized industry or trade usage, or the major groups recognized by the SIC. *Id.* § 1.994-1(c)(7)(ii).

Before calculating DISC CTI, the taxpayer must allocate its costs between export sales and domestic sales. The costs of goods sold are determined according to 26 C.F.R. § 1.61-3. *Id.* § 1.994-1(c)(6)(ii). Other costs "which shall be treated as relating to the gross receipts from sales of export property are (a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses or other deductions which are *not definitely related* to a class of gross income,

determined in a matter consistent with the rules set forth in 1.861-8." *Id.* § 1.994-1(c)(6)(iii) (emphasis added).[6] Neither the § 1.994 regulations nor the I.R.C. define "definitely related" other than by reference to § 1.861-8.

Section 1.861-8(b)(2) states "[a] deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." *Id.* § 1.861-8(b)(2). Recognizing that "research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development," § 1.861-8(e)(3)[7] provides:

> Expenditures for research and development which a taxpayer deducts under section 174 shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories) . . . . The individual products included within each category are enumerated in the . . . Standard Industrial Classification Manual.

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[6] The regulations offer the following as examples of deductions that are generally considered "not definitely related" to any class of gross income — personal interest expense, real estate and sales taxes, medical expenses, charitable contributions, and alimony payments. See 26 C.F.R. § 1.861-8(e)(9)(i) -(v).

[7] In 1996, the provisions of § 1.861-8(e)(3) were renumbered and, with amendments not relevant to this appeal, were republished as Treas. Reg. § 1.861-17.

The district court, relying on *St. Jude Medical*, determined that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC CTI computations. In *St. Jude Medical*, the Eighth Circuit identified three reasons why § 1.861-8(e)(3) did not control the computation of DISC combined taxable income. See *St. Jude Medical*, 34 F.3d at 1401-02. First, the court determined that § 1.861-8(e)(3)'s requirement that the taxpayer group its sales under a broad SIC code conflicted with Congress's intent to permit taxpayers to allocate costs by product or product lines under § 1.994-1(c)(6)(iv) & (c)(7). *Id.* at 1401. Second, the court found section § 1.861-8(e)(3)(i)'s "deemed" relationship between R&D costs and export sales conflicted with Congress's intent to allocate to each item of gross income only the expenses directly related thereto. *Id.* Third, the court determined that § 1.861-8(e)(3)'s dictate that "gross income derived from successful research and development bear the cost of unsuccessful research and development" was inconsistent with Congress's intent that CTI computations include only those costs that are directly related to the production or sale of export property. *Id.* Applying a reasonableness standard of review,[8] the Eighth Circuit concluded that Treas. Reg. § 1.861-8(e)(3) was unreasonable and invalid as applied to Boeing's DISC CTI computations under § 1.994-1(c)(6) & (7). *Id.* at 1402.

We decline to follow the reasoning of *St. Jude Medical*. Instead, we agree with the Commissioner that Treas. Reg.

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[8] The Eighth Circuit considered "whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose." *Id.* at 1400 (quoting *Nat'l Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477, 59 L. Ed. 2d 519, 99 S. Ct. 1304 (1979)). The court also considered "the span of time between the enactment of the statute and promulgation of the regulation, the length of time the regulation has been in effect, the evolution of the regulation, the reliance placed on the regulation, the consistency of the Commissioner's interpretation, and the degree of congressional scrutiny." *Id.*

§ 1.861 8(e)(3) is consistent with the guidance provided by the relevant I.R.C. provisions. Under I.R.C. § 994(a)(2), CTI is to be calculated based on revenue and costs "attributable to" sales in the applicable year. This statutory text does not confine the relevant costs to those "definitely related" to sales of a particular product.

The legislative history supports this position. The applicable House Report states:

> [T]he combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income . . . .These rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis. Thus the combined taxable income . . . would be determined by deducting from the DISC's gross receipts the . . . cost of goods sold with respect to the property [and the expenses] of both the DISC and the related person which are *directly related* to the production or sale of the export property and a portion of the related person's and the DISC's expenses *not allocable to any specific item of income*, such portion to be determined based on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.

H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887-1888 (emphasis added).

This House Report reflects that Congress recognized some of the costs incurred in a given tax year would not be "directly related" to specific income items. The Report further reflects Congress's intention that those costs not "directly related" would be allocated to export-related sales on a pro rata basis. The Commissioner's application of Treas. Reg. § 1.861-8(e)(3) effectuates this Congressional intent.

There is no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6). The latter simply substitutes the term "definitely related" for "directly related." Like House Report 92-533, Treas. Reg. § 1.994-1(c)(6) contemplates that costs which are not "definitely related" to specific items of income in a given year will be allocated to the combined taxable income of the taxpayer's export-related business. Treas. Reg. § 1.994-1(c)(6) is clear in explaining that "total costs . . . which relate to" the receipts from export sales will be allocated to the combined taxable income from such sales and that those "total costs" include both "definitely" and "indefinitely" related costs.

To the extent there is any tension between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7), the regulations can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3).[9] Interpreted in this way, the regulations may be read to give effect to both. See, *e. g.*, *United States* v. *Borden Co.*, 308 U.S. 188, 198, 84 L. Ed. 181, 60 S. Ct. 182 (1939) ("It is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject, the rule is to give effect to both if possible."); see also *Black & Decker Corp.* v. *Commissioner*, 986 F.2d 60, 65 (4th Cir. 1993) (explaining that the tenets of statutory construction apply with equal force to the interpretation of regulations).

We are unpersuaded that Congressional inaction weighs in favor of either of the parties. Since 1977, when the IRS first

[9] If the regulations were truly in conflict, Treas. Reg. § 1.861-8(e)(3) would likely control as the later and more specific regulation. See *United States* v. *Carper*, 24 F.3d 1157, 1159 (9th Cir. 1994).

promulgated Treas. Reg. § 1.861-8(e)(3), Congress has both amended the DISC statutory scheme and enacted temporary legislation governing the allocation of R&D costs in other contexts. The government argues that Congress's failure to legislatively override Treas. Reg. § 1.861-8(e)(3) as to the computation of DISC CTI signals Congress's approval of that regulation's method for computing such income.[10] The tax court in *St. Jude Medical* relied in part on this argument. See *St. Jude Med., Inc.* v. *Commissioner*, 97 T.C. 457, 485 (1991) ("Congress has repeatedly considered the regulations at issue and ...has neither modified the allocation and apportionment regulations as applied to the computation of combined taxable income nor expressed its disapproval of the regulations."), *aff'd in part and rev'd in part by*, 34 F.3d 1394 (8th Cir. 1994). On the other hand, the Eighth Circuit discounted this argument in *St. Jude Medical*, 34 F.3d at 1402 n. 15, and Boeing argues Congress has failed to act in the seven years since the Eighth Circuit in *St. Jude Medical* determined that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC income determinations. *Id.* at 1402.

The most that can be said from these competing arguments is that Congressional inaction provides no reliable indication of how this case should be resolved. Treas. Reg. § 1.861-8(e)(3), however, is a reasonable interpretation of the applicable statutes and regulations. As such, it provides the proper method for allocating Boeing's R&D costs attributable to its export sales of commercial airplanes. Accordingly, we reverse the district

[10] Beginning with the Economic Recovery Tax Act of 1981 § 223, Pub. L. No. 97-34, 95 Stat. 172, 249, Congress placed a two-year moratorium on Treas. Reg. § 1.861-8(e)(3) to the extent it was being used to determine whether particular income was foreign source or United States source income. This moratorium was extended an additional two years by the Deficit Reduction Act of 1984 § 126, Pub. L. No. 98-369, 98 Stat. 494, 648 and an additional year by the Consolidated Omnibus Budget Reconciliation Act of 1985 § 13211, Pub. L. No. 99-272, 100 Stat. 82, 324.

court's summary judgment for $419,110,539 in favor of Boeing. We also reverse the district court's partial summary judgment for approximately $1 million in favor of the government, and remand to the district court for further proceedings consistent with this opinion.

REVERSED and REMANDED.

APPENDIX B

No. C96-1990C

UNITED STATES DISTRICT COURT
for the Western District of Washington

THE BOEING COMPANY (and consolidated subsidiaries)
and BOEING SALES CORPORATION,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

September 10, 1998, Decided

ORDER

COUGHENOUR, Chief Judge.

In this taxpayer refund case, the parties cross-move for summary judgment. Having considered all of the files and pleadings herein, and having heard oral argument, the Court GRANTS summary judgment in favor of plaintiffs.

INTRODUCTION

Plaintiffs ("Boeing") sue for the refund of over $446 million in federal income tax and assessed interest paid for the taxable periods 1979 through 1987. The case arises in the context of a special set of incentive provisions in the Internal Revenue Code ("IRC") allowing a U.S. taxpayer to defer or exempt from tax a portion of its net income on export sales if the property is sold through a subsidiary established as a domestic international sales corporation ("DISC") or a foreign sales corporation ("FSC"). Boeing thus has a substantial incentive under those provisions to increase net income from export sales by reducing the amount of deductions on its export sales. In the instant case, Boeing challenges the manner in which the IRS allocated and

apportioned over $1 billion in research and development ("R&D") costs in determining the net income of Boeing's DISC/FSC. Specifically, Boeing argues that Treasury Reg. § 1.861-8(e)(3) is illegal when applied to DISC/FSC combined taxable income ("CTI") computations.

FACTUAL BACKGROUND

The parties have stipulated to the facts relevant to the instant motions. During the years at issue, Boeing was the world's leading manufacturer of commercial airplanes and one of the country's largest exporters. On average, approximately 70% of Boeing's commercial airplane sales by dollar volume consisted of qualified export sales. From 1972 until 1984, Boeing exported commercial airplanes and related goods and services through its subsidiary, Boeing International Sales Corporation ("BISC"), a qualified DISC under I.R.C. § 992. After 1984, Boeing exported commercial airplanes and related goods and services through its subsidiary, Boeing Sales Corporation, a qualified FSC, under I.R.C. § 922.

For the time period in question, Boeing contends that it established or maintained separate Programs of each of its major commercial airplane product lines — the 707, the 727, the 737, the 747, the 767, the 757 and the 737-300. Within each Program, Boeing developed several different models (or "derivatives"), such as a passenger and cargo version of the 747. Each of Boeing's Programs is a separate product or product line in conformance with industry practice and trade usage in the commercial airplane business. The initial airplane in each of the Programs at issue, with the exception of the 737-300, was required to obtain a new type certification from the Federal Aviation Administration ("FAA"). The certificate sets forth the applicable regulatory requirements that the airplane has met.

Boeing classifies its R&D costs into two broad categories — "Blue-Sky R&D," incurred before the Program Go Ahead ("PGA") for a new airplane Program or major model derivative,

and Program R&D, also referred to as Company Sponsored Product Development ("CSPD"), incurred after PGA. CSPD expenditures represent approximately 77% of the R&D amounts at issue in this case. PGA is the point at which Boeing makes the firm business decision and commitment to produce a particular airplane model and the decision is made by the Board of Directors. Blue Sky R&D goes to basic research relating to commercial airplanes, such as research in the field of aerodynamics or avionics and to concept research aimed at identifying new commercial airplanes, that might adapt new technology to achieve a new market niche. Blue Sky R&D may be a precursor to a specifically identified Program, although the majority of Blue Sky projects never become Programs. CSPD is Program-specific and includes the cost of designing, developing, testing, and qualifying a particular new airplane model for commercial service with an FAA type certification. The majority of those costs are nonrecurring.

Under Boeing's cost accounting system, Blue-Sky R&D was allocated to all Programs and apportioned among them. CSPD R&D, on the other hand, was charged directly to the Programs in which they were incurred, and deducted on a current year bases regardless of whether there were any sales in the corresponding Program that year. During the years at issue, for financial accounting purposes, the Blue-Sky and CSPD R&D costs were expensed in the period in which they were incurred. And, for overall federal income tax purposes, all the R&D costs were deducted in the period they were incurred.

For purposes of calculating the intercompany price and profits from its export sales, Boeing chose the combined taxable income ("CTI") method under § 994(a)(2) and § 925(a)(2) of the Code. To calculate CTI, Boeing chose to "group" its export sales by airplane Program under Treas. Reg. § 1.994-1(c)(7). Boeing relied on its cost accounting system and the resulting identification of costs and expenses, including R&D, chargeable to the specific Program. Boeing's method charged the R&D to the specific program even if there were no

sales in the Program in the same year in which the CSPD R&D on that Program was incurred, and it would not be charged again against Program sales in later years.

Upon an audit, the IRS rejected Boeing's method of calculating CTI, claiming that Boeing's method made R&D effectively "disappear" for CTI purposes. The IRS instead applied Treas. Reg. § 1.861-8(e)(3), which provides that R&D expenses should be deemed related to all sales within the broad product categories set forth in the Standard Industrial Classification ("SIC") published by the Office of Management and Budget. All of Boeing's sales of commercial airplanes falls into SIC code 37, Transportation Equipment. Accordingly, for a given year, the IRS allocated all of Boeing's R&D expenses (Blue-Sky and CSPD) to all of Boeing's income from sales of commercial airplanes and then apportioned those R&D expenses among Boeing's airplane Programs on the basis of sales. All of the R&D is thus deducted against the revenue from Boeing's commercial airplanes sales for that year, whether or not the R&D is factually related to those sales.

ANALYSIS

Given the stipulated facts submitted by the parties, these summary judgment motions present a pure legal question: whether Treas. Reg. § 1.861-8(e)(3) may be applied to Boeing's DISC/FSC CTI computations. This is not a question of first impression. The Eight Circuit dealt with precisely this question in *St. Jude Medical, Inc.* v. *C.I.R.*, 34 F.3d 1394, 1396 (8th Cir. 1994). After examining the legislative intent behind the DISC and the applicable regulations, the Eight Circuit squarely held that "§ 1.861-8(e)(3) is invalid as applied to DISC CTI computations." The Court found that § 1.861-8(e)(3) was unreasonable as applied to the DISC statute as it did not "harmonize[] with the plain language of the statute, its origin, and its purpose." *Id.* at 1402. This Court finds the reasoning and

analysis in *St. Jude* to be persuasive and applicable to the current case.[1]

I. Statutory Framework

The *St. Jude* court set out in detail the statutory framework governing the calculation of CTI for a DISC/FSC, which this Court will summarize briefly. In 1971, Congress enacted the DISC provisions, I.R.C. §§ 991-997, as a tax incentive to encourage and increase exports of products by U.S. manufacturers. *St. Jude*, 34 F.3d at 1396. In 1984, the FSC provisions were enacted to replace and cure some shortcomings in the DISC provisions. Deficit Reduction Act of 1984, Pub. L. 98-369, § 801(a), 98 Stat. 494, 990; S. Rep. No. 98-169, at 636 (1984). Qualified DISC/FSC corporations are not subject to tax. Instead, the parent corporation is taxed on a specified portion of the DISC profits as a deemed distribution. I.R.C. § 995; *L&F Intl. Sales Corp.* v. *United States*, 912 F.2d 377, 378 (9th Cir. 1990). The remaining DISC profits are tax deferred until distributed to the parent or until the DISC ceases to qualify as a DISC. § 995(a) and (b). The FSC provisions permanently exempt a portion of FSC profits from tax. § 923(a).

Under the DISC statute, Congress also created intercompany pricing rules which provide for the price at which the parent corporation is deemed to have sold its products to the DISC corporation. The intercompany pricing rules were intended to "avoid the complexities of the [arms length] pricing rules in the

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[1] The *St. Jude* court said that a tax regulation must be a reasonable interpretation of the congressional mandate in order to be upheld. 34 F.3d at 1400. The government argues that the appropriate standard of review should be governed by the standard set forth in *Chevron USA* v. *Natural Resources Defense Council*, 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1984). Even if that is the case, however, the *Chevron* standard still requires a reasonable interpretation of a statute. See *Redlark* v. *C.I.R.*, 141 F.3d 936, 939 (9th Cir. 1998) (courts "will not override the agency's reasonable construction" of statute). *St. Jude* found § 1.861-8(e)(3) to be an unreasonable construction.

case of sales by a domestic corporation . . . to a DISC and also to provide encouragement for the operation of DISC's." 34 F.3d at 1397 (quoting H.R. Rep. No. 533 at 73, reprinted in 1971 U.S.C.C.A.N. at 1887). The rules allowed a DISC corporation profit in excess of arm's length rules and regardless of the sales price actually charged. *Id.* The rules also served to "limit[] the amount of income of which the parent can defer realization," *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995), by fixing a transfer price so that the entire amount of export sales would not be deferred, but only the amount computed under the statute.

Under the DISC intercompany pricing rules, taxpayers may choose between three pricing methods to achieve the largest amount of income allocation to DISC. See I.R.C. § 994. Boeing chose the combined taxable income, "CTI," method for its DISC/FSC. I.R.C. § 994(a)(2) states that the DISC is entitled to fifty percent of the "combined taxable income . . . attributable to the qualified export receipts" for the property.[2] The statute does not further define CTI. That definition is found in Treas. Reg. § 1.994-1(c)(6), which defines CTI as "the excess of gross receipts . . . from such a sale over the total costs of the DISC and related supplier which relate to such gross receipts."

Treas. Reg. § 1.994-1(c)(6)(iii) provides that the costs fall into three categories: (1) costs of goods sold, (2) costs that are "definitely related" to export property, and (3) costs that "are not definitely related to a class of gross income." Taxpayers must allocate their costs between export sales and domestic sales to compute CTI. Rather than creating a new method of cost allocation within the DISC provisions, Congress intended that CTI costs computations "be determined generally in

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[2] Although there are some differences between the DISC and FSC provisions, the parties agree that the calculation of the CTI on export sales is essentially the same for both. See *General Dynamics*, 108 T.C. 107 at 116.

accordance with the principles applicable under [I.R.C.] section 861." *St. Jude*, at 1401. Treas. Reg. § 1.861-8(e)(3) provides the general rules for allocating and apportioning R&D under I.R.C. § 861 and deems a definite relationship between an R&D expenditure and a broad SIC product category. 34 F.3d at 1399.

At the same time, Treas. Reg. § 1.994-1(c)(6)(iv) provides that the taxpayer's grouping choice under § 1.994-1(c)(7) "shall be controlling and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." In this case, Boeing chose to group according to a recognized industry/trade usage, *i.e.* product line, and not the SIC code category, a choice that is not only allowed, but controlling.

II. The Application of § 1.861-8(e)(3) to DISC/FSC CTI Computations

The conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)(iv) as applied to CTI computations was resolved in Boeing's favor in *St. Jude*. St. Jude was a U.S. corporation that incurred R&D related to three different products: an insulin pump, a cardiac pacemaker, and an artificial heart valve. St. Jude exported heart valves through its DISC, but never sold the insulin pump or cardiac pacemaker. St. Jude used the CTI method to calculate DISC transfer prices and grouped each of its three products separately under Treas. Reg. § 1.994-1(c)(6)(iv) and (c)(7), so that no portion of the R&D expenses for the insulin pump and pacemaker were allocated to export receipts from heart valves. The IRS applied § 1.861-8(e)(3) to all three products and grouped them under SIC Code 38, so that all R&D expenses effectively were charged against export sales of heart valves in computing CTI.

The *St. Jude* court found three primary defects with such an application of § 1.861-8(e)(3). The first defect is that the § 1.861-8(e)(3) requires grouping according to a two-digit SIC Code, which conflicts with Congress's intent to allow costs to

be allocated on a product-by-product basis or on the basis of product lines. See *St. Jude*, 34 F.3d at 1401. The second defect is that the "deemed" relationship mandated by § 1.861-8(e)(3) is inconsistent with Congress's intent to "generally allocate to each item of gross income all expenses *directly related thereto*." *St. Jude*, 34 F.3d at 1401 (emphasis in original). The third defect is that the SIC categories requiring "gross income derived from successful research and development [to] bear the cost of unsuccessful research and development" is inconsistent with Congress's intent to deduct only those costs "directly related to the production or sale of the export property." *Id.*

The government provides little resistance to the first two defects identified by *St. Jude*. It argues that there is no conflict between the mandated SIC grouping in § 1.861-8(e)(3) and the taxpayer elected grouping of § 1.994-1(c)(6)(iv) and (c)(7) because the grouping choice in § 1.861-8(e)(3) is somehow an exception to § 1.994-1(c)(6)(iv) when computing CTI. The government's only citation for that proposition, however, is the tax court decision in *St. Jude* which was reversed by the Eighth Circuit.

The government also argues that § 1.994-1(c)(6)(iv) and (c)(7) were merely for "administrative convenience" and using the grouping provisions to increase tax savings would be inconsistent with the purpose of CTI, which the government suggests is to limit the amount of tax savings available to taxpayers under the DISC/FSC provisions. The government reads too much into *Intel Corp.* in search of support for its proposition that CTI was meant to limit tax savings regardless of § 1.994-1(c)(6)(iv) and (c)(7). *Intel Corp.*'s description of the intercompany pricing rules merely recognizes that in the context of an incentive provision designed to allow "domestic exporters to enjoy a deferral of tax on their export earnings somewhat similar to that available to exporters who utilized foreign subsidiaries," [76 F.3d at 981, the exporters should enjoy a partial but not complete deferral.

The government seems to use the third defect as the basis for their argument that *St. Jude*'s holding should be limited to R&D on unsuccessful products. However, while the difference between successful and unsuccessful R&D was an important factor in *St. Jude*, its holding and analysis did not turn on that distinction. Indeed, it is the very nature of R&D that it cannot be known in advance whether or not the R&D effort will be successful and if successful, when it will be successful. If the development of a new product takes several years, it makes no sense for the taxpayer to apply Treas. Reg. § 1.861-8(e)(3) for the first years when the R&D has not resulted in sales, and then follow *St. Jude* in a subsequent year when there have been sales. Thus, although one of the defects of § 1.861-8(e)(3) is not applicable here, the other two are; and those defects are fatal.

The government also attempts to distinguish *St. Jude* by arguing that it did not address the issue of "total costs," referred to in § 1.994-1(c)(6), that is presented here. In fact, however, the *St. Jude* court rejected the government's argument that "total costs" should be calculated by deducting R&D from all export sales for the year, not just for a Program to which the R&D is related. *St. Jude* considered § 1.994-1(c)(6) and concluded that Congress intended an actual relationship, rather than a deemed relationship, between the export gross receipts and the expense in question, and that § 1.861-8(e)(3)'s "deeming" of a relationship violated Congress's intent. Thus, under *St. Jude*, "total costs" is calculated by deducting the R&D from the income to which the R&D is actually related, not from the total income of a DISC/FSC for any given year.

General Dynamics Corp. & Subsidiaries v. *Commissioner*, 108 T.C. 107 (1997), does not support the government's position either. Preliminarily, *General Dynamics* dealt with the definition of "total costs" on a very different set of facts. General Dynamics used the completed contract method of accounting for long-term contracts for federal income tax purposes. Normally, under the completed contract method, income and expenses connected with long-term contracts are

not reported or claimed until the completion of the contract, so General Dynamics did not recognize income from its long-term contracts until the year that the contract was completed. General Dynamics elected, however, to deduct certain period costs, including marketing and selling expenses, distribution expenses, pension and profit-sharing contributions, but not R&D, in the year incurred. The Tax Court found that those costs were not definitely related to income other than export sales, so they had to be accounted for in determining CTI when income was received from the completed contracts. 108 T.C. at 124-25.

More importantly, however, applying *General Dynamics* here would arrive at a result inconsistent with § 1.861-8(e)(3). The government's method of computing CTI reduces the CTI for a current Program within a given year (*i.e.*, sales of 747's in 1980) by the R&D incurred for a different Program that same year (*i.e.*, 757 R&D incurred in 1980). Under the approach in *General Dynamics*, however, because it is premised on the completed contract accounting method, current R&D (*i.e.*, 757 R&D incurred in 1980) would be currently deducted whether or not there was a sale in the Program, and not charged against the export sales in the Program until a sale was made (*i.e.*, 757 sales in 1981).

CONCLUSION

Accordingly, summary judgment is GRANTED in favor of plaintiffs.

APPENDIX C

No. 99-35818, 99-35857

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THE BOEING COMPANY, and
Consolidated Subsidiaries; BOEING SALES
CORPORATION,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

THE BOEING COMPANY, and
Consolidated Subsidiaries, Plaintiff, and
BOEING SALES CORPORATION,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

November 19, 2001

Before: THOMPSON, TROTT, and PAEZ, Circuit Judges

The panel, as constituted above, has unanimously voted to deny appellee Boeing's petition for rehearing. Judges Trott and Paez have also voted to deny its petition for rehearing by the court en banc, and Judge Thompson has recommended that petition be denied.

The full court has been advised of the petition for court rehearing en banc, and no judge of the court has requested en banc rehearing. See Fed. R. App. P. 35(b).

The petition for panel rehearing and for rehearing by the court en banc are DENIED.

APPENDIX D

26 U.S.C. § 861 (1979)

§ 861. Income from sources within the United States.

(a) GROSS INCOME FROM SOURCES WITHIN UNITED STATES. – The following items of gross income shall be treated as income from sources within the United States:

* * *

(b) TAXABLE INCOME FROM SOURCES WITHIN UNITED STATES. – From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable par of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the zero bracket amount shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

* * *

APPENDIX E

26 U.S.C. § 994 (1979)

§ 994. Inter-company pricing rules.

(a) In general. In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

(b) Rules for commissions, rentals, and marginal costing. The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a DISC is seeking to establish or maintain a market for export property.

(c) Export promotion expenses. For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the

United States, but does not include income taxes. Such expenses shall also include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by United States persons or ships documented under the laws of the United States in those cases where law or regulations does not require that such property be shipped aboard such airplanes or ships.

APPENDIX F

26 C.F.R. 1.994-1 (1979)

§ 1.994-1 Inter-company pricing rules for DISC's.

(a) In general -- (1) Scope. In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c) (2), (3), and (4) of this section: The "4 percent" gross receipts method, the "50-50" combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain "incomplete transactions" and for computing combined taxable income, see paragraph (c) (5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in

paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994-2 prescribes the marginal costing rules authorized by section 994(b)(2).

* * *

(c) Transfer price for sales of export property – (1) In general. Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) The "4-percent" gross receipts method. Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) The "50-50" combined taxable income method. Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) Section 482 method. If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on

the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) Incomplete transactions. (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year –

(a) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(b) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(c) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (b) of this subdivision.

(d) The time and manner of payment of transfer prices required by (b) and (c) of this subdivision shall be determined under paragraph (e) (3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier

and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) Combined taxable income. For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See § 1.991-1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631

applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of § 1.993-1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) Grouping transactions. (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) A recognized industry or trade usage, or (b) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

* * *

APPENDIX G

26 C.F.R. § 1.861-8 (1979)

§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities

(a) *In general* – (1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 8761(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and then, if necessary to make the determination required by the operative section of the

Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income.

* * *

(b) *Allocation* – (1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the tax-payable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a

taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example (17) of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned

along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could reasonably have been expected to generated gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples (19) through (21) of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities.

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of the gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions* – (1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be

apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. If the class of gross income to which a deduction has been allocated is included in its entirety in either a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in the statutory grouping or in each of the statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which there is an excess of deductions. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to–

(i) Comparison of units sold attributable to the statutory grouping and attributable to the residual grouping;

(ii) Comparison of the amount of gross sales or receipts;

(iii) Comparison of costs of goods sold;

(iv) Comparison of profit contribution;

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the

activities or properties giving rise to the class of gross income; and

(vi) Comparison of the amount of gross income in the statutory grouping with the amount in the residual grouping.

Paragraphs (e)(2) through (e)(8) of this section provide the applicable rules for allocation and apportionment of deductions for interest, research, and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) of this section may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not definitely related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(2) of this section.

(2) *Deductions not definitely related to any gross income.* If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross

income in the residual grouping bears to the total amount of gross income.

(d) *Excess of deductions and excluded and eliminated income* – (1) *Excess of deductions.* Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See § 1.1502-4(d)(1) and the last sentence of § 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example (17) of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded or eliminated income.* In allocating or apportioning deductions to classes or statutory groupings of gross income, including apportionment pursuant to paragraph (c)(2) of this section (deductions not definitely related to any class of gross income), gross income shall include amounts which are otherwise exempt or excluded (such as the income of a nonresident alien individual or foreign corporation which is not effectively

connected income) or which are otherwise eliminated in the computation of consolidated taxable income reported for the taxable year on a consolidated return (but deferred intercompany transactions, as defined in § 1.1502-13, shall not be included until the year they are included in taxable income). Hence, a deduction may be allocated and apportioned to exempt, excluded, or eliminated income. See example (24) of paragraph (g) of this section. No deduction shall be allowed, under this section, for any amount, or part thereof, allocable and apportionable to a class of exempt, excluded, or eliminated income, if such amount is not allowed as a deduction under another section of the Code. See section 265 and the regulations thereunder.

(e) *Allocation and apportionment of certain deductions* – (1) *In general* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraphs (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

* * *

(3) *Research and experimental expenditures* – (i) *Allocation* – (A) *In general.* The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of

unsuccessful research an development. Expenditures for research and development which a taxpayer deducts under section 174 shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) which a taxpayer may be considered to have shall be limited to the following list. Ordinarily a taxpayer's research and development expenditures may be divided between the relevant product categories. Where research and development is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories in this list. Where research and development is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and budget, Standard Industrial Classification Manual, 1972 (or later edition, as available).

SIC Major Groups	*Nonmanufactured categories*
(01, 02 ,07, 08, 09).....	Agriculture, forestry and fisheries.
(10, 11, 12)	Hard mineral mining.
(13)	Crude petroleum, and natural gas.
(14)	Nonmetallic minerals.
(15, 16, 17)	Construction services.
(40, 41, 42, 43, 44, 45, 46, 47)	Transportation services.
(48)	Communication.

SIC Major Groups	*Nonmanufactured categories*
(49)	Electric, gas and sanitary services.
(50, 51)	Wholesale trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories).
(52, 53, 54, 55, 56, 57, 58, 59)	Retail trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except Wholesale trade, and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except Wholesale trade).
(60, 61, 62, 63, 64, 65, 66, 67)	Finance, insurance, and real estate.
(70, 72, 73, 75, 76, 78, 79, 80, 81, 82, 83, 84, 86, 88, 89)	Other services.
(20)	Food and kindred products.
(21)	Tobacco manufacturers.
(22)	Textile mill products.

SIC Major Groups	*Nonmanufactured categories*
(23)	Apparel and other finished products made from fabrics and similar materials.
(24)	Lumber and wood products, except furniture.
(25)	Furniture and fixtures.
(26)	Paper and allied products.
(27)	Printing, publishing, and allied industries.
(28)	Chemicals and allied products.
(29)	Petroleum refining and related industries.
(30)	Rubber and miscellaneous plastics products.
(31)	Leather and leather products.
(32)	Stone, clay, glass and concrete products.
(33)	Primary metal industries.
(34)	Fabricated metal products, except machinery and transportation equipment.
(35)	Machinery, except electrical.
(36)	Electrical and electronic machinery, equipment and supplies.
(37)	Transportation equipment.

SIC Major Groups	*Nonmanufactured categories*
(38)	Measuring, analyzing, and controlling instruments; photographic, medical and optical goods, watches and checks.
(39)	Miscellaneous manufacturing industries.

(B) *Exception.* Where research and development is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generage amounts of gross income (beyond de minimis amounts) outside a single geographic source, the deduction for such research and development shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in subdivisions (ii)(B) and (iii) of this paragraph (e)(3)). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(ii) *Apportionment of research and development – sales method* – (A) *Exclusive apportionment.* Where an apportionment based upon geographic sources of income of a deduction for research and development is necessary (after applying the exception in subdivision (i)(B) of this paragraph (d)(3), an amount equal to –

(1) Fifty percent (50%), in the case of a taxable years beginning during 1977.

(2) Forty percent (40%), in the case of a taxable year beginning during 1978.

(3) Thirty percent (30%), in the case of a taxable year beginning during 1979, and thereafter,

of such deduction for research and development shall be apportioned exclusively to the statutory grouping of gross income, or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and development activities which account for more than fifty percent (50%) of the amount of such deduction were performed. If the fifty percent test of the preceding sentence is not met, then no part of the deduction shall be apportioned under this subdivision (ii)(A). This exclusive apportionment reflects the view that research and development is often most valuable in the country where it is performed, for two reasons. First, research and development often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of which may be sold in foreign markets. Second, research and development often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater percent then the relevant percent specified in *(1)*, *(2)* or *(3)* of this subdivision (ii)(A) because the research and development is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as

defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for non-manufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget *Standard Industrial Classification Manual*, 1972 or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level on pages 5 through 200 of U.S. Bureau of the Census, *Census of Manufactures: 1972, Numerical List of Manufactured Products (New (1972) SIC Basis)*, 1973, (or later edition, as available). Examples (9), (10), and (13) in paragraph *(g)* of this section illustrate the application of this rule. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and processes (not limited by those listed in the *Standard Industrial Classification Manual or the Numerical List of Manufactured Products)* in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under (C) of this subdivision (ii)) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under (D) of this subdivision (ii)) which can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of taxpayer's research, that another discount rate is more appropriate (see examples (9) through (12) in paragraph (g) of this section).

(B) *Remaining apportionment.* The amount equal to the remaining portion of such deduction for research and

development, not apportioned under (A) of this subdivision (ii), shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) which resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories). For the purposes of this paragraph *(e)(3)*, amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year. Amounts apportioned under this paragraph *(e)(3)* may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See paragraph (d)(1) of this section for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(C) *Sales of uncontrolled parties.* For purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property which was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate should be made. In the case of sales of intangible property, and in cases where a

reasonable estimate of sales of licensed products cannot be made, the sales taken into account shall be an amount which is ten times the amount received or secured for the intangible during the taxpayer's taxable year. For purposes of this subdivision (ii)(C), the term "uncontrolled party" means a party which is not a person with a relationship to the taxpayer (specified in section 267(b)), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993 (a)(3). An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party, or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs.

(D) *Sales of controlled parties.* For purposes of the apportionment under purposes of the apportionment under (B) of this subdivision (ii), the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (of categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in *(1)* or *(2)* of this subdivision (ii)(D) for determining the taxpayer's apportionment, fi such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category or categories). However, sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corporation shall be subtracted from the sales of the buying corporation. For purposes of this subdivision (ii)(D), the term "a corporation controlled by the taxpayer" means any

corporation other than an "uncontrolled party" as defined in (C) of this subdivision (ii). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be exptected to license, sell, or transfer intangible property to that corporation, or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and development shall be considered in determining reasonable expectations. However, if the corporation controlled by the taxpayer has entered into a bonafide cost-sharing arrangement, in accordance with the provisions of § 1.482-2(d)(4), with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense. The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be the greater of–

(1) The amount of sales that would have been taken into account under paragraph (e)(3)(ii)(C) of this section if the controlled corporation were an uncontrolled party and if any intangible property contributed by the taxpayer to the controlled corporation were treated as a license of that intangible property; or

(2) The amount of sales that bear the same proportion to total sales of the controlled corporation as the taxpayer's direct or indirect ownership, as defined in section 1563, of the total combined voting power of all classes of stock entitled to vote of such corporation bears to the total outstanding combined voting power of all such classes of stock of such corporation.

(iii) *Apportionment of research and development – optional gross income methods.* If the conditions of either (A) or (B) of this subdivision (iii) are met, in lieu of apportioning the deduction for research and development expense under

subdivision (ii) of this paragraph (e)(3), a taxpayer may, at his option, for any taxable year apportion such deduction, as prescribed in (A) or (B) of this subdivision (iii), between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income. These optional methods must be applied to the taxpayer's entire deduction for research and development expense remaining after applying the exception in subdivision (i)(B) of this paragraph (e)(3), and may not be applied on a product category basis. However, if any member of an affiliated group which files a consolidated return apportions its research and development expense for a taxable year under this subdivision (iii), then all members joining that return must use this subdivision (iii) for such taxable year.

(A) *Option One.* If, when apportioned ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount of gross income.

(1) The amount of research and development expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3), and

(2) The amount of research and development expense ratably apportioned to the residual grouping is not less than fifty percent (50%) of the amount which would have been so apportioned if the taxpayer had used the method described in subdivision (ii) of this paragraph (e)(3).

then the taxpayer may apportion his research and development expense ratably on the basis of gross income.

(B) *Option Two.* If, when the amount of research and development expense is apportioned ratably on the basis of gross income, either condition (1) or (2) of (A) of this subdivision (iii) is not met, the taxpayer may either:

(1) Where condition (1) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the statutory grouping (or groupings in the aggregate) under subdivision (ii) of this paragraph (e)(3) to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and development expenses to the residual grouping; or

(2) Where condition (2) of (A) of this subdivision (iii) is not met, apportion fifty percent (50%) of the amount of research and development expense which would have been apportioned to the residual grouping under subdivision (ii) of this paragraph (e)(3) to such residual grouping, and apportion the balance of the amount of research and development expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(iv) *Examples.* Examples (3) through (16) and example (23) of paragraph (g) of this section illustrate the allocation and apportionment of research and development deductions.

* * *

No. 01-1209

APR 29 2002

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1979-1984 under the provisions of the Internal Revenue Code pertaining to "domestic international sales corporations" (26 U.S.C. 991-997 (1976 & Supp. III 1979)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury regulations.

2. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1985-1987 under the provisions of the Internal Revenue Code pertaining to "foreign sales corporations" (26 U.S.C. 921-927 (1988)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury regulations.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 258 F.3d 958. The opinion of the district court (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001. A petition for rehearing was denied on November 19, 2001 (Pet App. 25a). The petition for a writ of certiorari was filed on February 15, 2002. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 861 and 994 of the Internal Revenue Code, 26 U.S.C. 861 and 994 (1976 & Supp. III 1979), and of 26 C.F.R. 1.861-8 and 1.994-1 (1979), as they were in effect in the years relevant to

this case, are set forth at Pet. App. 26a-53a. In addition to those provisions, the relevant portions of Section 925 of the Internal Revenue Code, 26 U.S.C. 925 (1988), of 26 C.F.R. 1.925(a)-1T (1989), and of 26 C.F.R. 1.861-17 are set forth at App., *infra*, 1a-11a.

STATEMENT

1. This case concerns the proper allocation of research and development expenses in the calculation of income from foreign sales of goods during the years from 1979 to 1987. This question arose under two separate sets of statutory and regulatory provisions, all of which have since been modified or repealed.

a. In 1971, Congress enacted provisions that established a separate tax status for "domestic international sales corporations" (DISCs). 26 U.S.C. 991-997 (1976 & Supp. III 197[illegible]. The DISC provisions sought to "provide substantial stimulus to exports and at the same time to avoid granting undue tax advantages." S. Rep. No. 437, 92d Cong., 1st Sess. 13 (1971). Under these provisions, a domestic manufacturer could form a DISC in the United States "the income of which is not taxed at the DISC level. Instead, the corporate shareholder was taxed directly on a portion of the DISC's income deemed distributed. The portion of the income not deemed distributed was not subject to any U.S. taxation until actually distributed." R. Doernberg, *International Taxation* 395-396 (4th ed. 1999).

Soon after their enactment, the DISC provisions were challenged by other Nations as impermissible export subsidies under the General Agreement on Tariffs and Trade. See R. Doernberg, *supra*, at 396. As a consequence of that international challenge, Congress replaced the DISC provisions in 1984 with the "foreign sales corporation" (FSC) provisions of the Code. 26

U.S.C. 921-927 (1988 & Supp. V 1993). See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b), 98 Stat. 1001-1002. When the FSC provisions were enacted in 1984, the DISC provisions were left in effect only "for small corporations" (with export receipts less than $10 million) and were revised to require the payment of interest on any deferred tax liability. 26 U.S.C. 995(b)(1)(E), 995(f) (1988). By thus imposing an interest charge on any deferred taxes under the post-1984 DISC provisions, the asserted export subsidy was removed (see R. Doernberg, *supra*, at 412), as was the economic incentive even for small corporations to employ the post-1984 DISC regime. As a consequence, taxpayers engaged in export operations after 1984 routinely did so under the FSC provisions.

b. The FSC provisions contemplate that a U.S. parent will establish a foreign corporation with a genuine foreign presence to conduct export sales. "If a corporation qualifies as a FSC, a portion of its foreign trade income is exempt from the U.S. corporate income tax [and] [t]hat portion can be distributed as a dividend tax-free to the U.S. parent corporation * * *." R. Doernberg, *supra*, at 397. Because the FSC may be subject to taxes abroad for its foreign sales income, "many U.S. corporations organize FSCs in foreign countries imposing relatively low, or no, corporate and dividend withholding taxes on that income." *Ibid.* Separate regulations were adopted to implement the new requirements of the FSC regime. See, *e.g*, 26 C.F.R. 1.925(a)-1T (1989).

c. In February 2000, the World Trade Organization determined that the FSC provisions that had superseded the DISC provisions provided a prohibited export subsidy in violation of the WTO Agreement on Subsidies and Countervailing Measures and the Agree-

ment on Agriculture. Appellate Body, World Trade Organizations, *United States—Tax Treatment for "Foreign Sales Corporations,"* AB-1999-9 (Feb. 24, 2000).[1] Following that decision, Congress repealed the FSC provisions as of September 30, 2000. With the exception of a narrow, transitional rule for certain transactions commenced under the FSC regime, Congress repealed and replaced the FSC provisions with the new "extraterritorial income exclusion" (ETI) of Section 114 of the Internal Revenue Code. 26 U.S.C. 114. See FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, § 5, 114 Stat. 2433. These new ETI provisions contain a degree of complexity that even the DISC and FSC provisions cannot rival.[2] The ETI provisions were again challenged in proceedings before the WTO, which led to the opinion of the WTO Appellate Body issued in January of 2002. Appellate Body, World Trade Organization, *United States—Tax Treatment for "Foreign Sales Corporations," Recourse to Article 21.5 of the DSU by the European Communities*, AB-2001-8, at 9-12 (Jan. 14, 2002).[3] In that opinion, the WTO Appellate Body concluded that the ETI provisions—like the FSC and DISC provisions

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[1] <http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm>

[2] Professors Bittker and Eustice noted that the original DISC provisions "quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14, at 17-43 (4th ed. 1979). When the FSC provisions were enacted to replace the DISC provisions in 1984, these same commentators remarked that the new provisions replaced the old with an "equally complex" statutory scheme that "def[ies] concise explanation." *Id.* ¶ 17.14, at 17-55 (5th ed. 1987).

[3] See note 1, *supra*.

that preceded them—constitute prohibited export subsidies under the WTO agreements. *Id.* at 91-93. The WTO Appellate Body further concluded that the narrow transitional rules that had left the FSC provisions temporarily in place for certain transactions were also in violation of the WTO agreements. *Id.* at 84.

2. a. The substantive question presented by the petition addresses one element of the complex requirements for computing what is known as the "combined taxable income" (CTI) of the parent and its sales subsidiary under the separate DISC (26 U.S.C. 994(a)) and FSC (26 U.S.C. 925(a)) tax regimes. The taxes imposed under these separate regimes vary depending on the amount of CTI that results from the covered export transactions. In general, under these tax provisions, the parent has an incentive to maximize the portion of its profits that are encompassed within its export-related CTI rather than within the parent's non-export related income, for this tends to reduce its overall tax burden. The taxpayer therefore seeks to minimize the portion of its overall costs that are allocated to its covered export transactions, which has the consequence of maximizing the portion of its overall profits that are allocated to the export-related CTI, and thereby reducing its overall tax burden.

b. While there are numerous differences between a DISC and a FSC, the principal one for the purposes of this case is that income tax on a portion of the export income attributed to a DISC is deferred, while a portion of the export income attributed to a FSC is exempt from income tax. Under both regimes, the combined taxable income of the parent and the sales subsidiary is an ingredient in the determination of the portion of that income that is allocated to the subsidiary and thus available for tax deferral or exemption. In the DISC

regime, the combined taxable income resulting from the sale is allocated based on an assumed transfer price for the exported good that would allow the DISC to derive income that does not exceed the greatest of (i) 4% of the export receipts, (ii) 50% of the combined taxable income of the parent and the DISC, or (iii) the income resulting from an arm's length sale price. 26 U.S.C. 994(a). The FSC regime has a similar, but different, allocation procedure that also, in some circumstances, requires or permits consideration of the combined taxable income of the parent and the sales subsidiary. 26 U.S.C. 925(a) (1988).[4]

Although these pricing rules are generally to be applied on a transaction-by-transaction basis, a taxpayer may choose instead to apply them to groups of exported goods consisting of products or product lines selected to determine the allowable transfer price. Different grouping regulations were adopted for this purpose under the DISC and FSC regimes. Compare 26 C.F.R. 1.994-1(a)(1), (c)(7)(i) (DISC), with 26 C.F.R. 1.925(a)-1T(a)(1), (c)(8) (FSC). The grouping rules make it unnecessary for the taxpayer to file a separate schedule for each and every sale, and they provide a limited flexibility in the choice of the pricing rule to apply. For example, the grouping rules would generally permit a taxpayer to elect the "4 percent of the qualified export receipts" pricing rule of Section 994(a)(1) for DISCs or the "1.83 percent of the foreign trading gross receipts" pricing rule of Section 925(a)(1) for FSCs to determine the allowable transfer price for

[4] Unlike the DISC, the FSC is a foreign corporation, and a portion of its foreign trade income is subject to United States tax. 26 U.S.C. 921, 923. For this reason, Boeing Sales Corporation (petitioner's FSC) is a party to this case. See note 9, *infra*.

one group of products, while employing the "50 percent of the combined taxable income" rule of Section 994(a)(2) for DISCs and the "23 percent of the combined taxable income" rule of Section 925(a)(2) for FSCs on another group of products.

c. Petitioner chose to use the "50 percent of the combined taxable income" price rule set forth in Section 994(a)(2) and the "23 percent of the combined taxable income" price rule set forth in Section 925(a)(2) for all of its groups of DISC and FSC export sales.[5] Although Congress never defined the term "combined taxable income" in either the DISC or the FSC statutes, Congress contemplated that "the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The rules established under Section 861 of the Internal Revenue Code, 26 U.S.C. 861, "generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross

[5] As used hereafter in this brief, the singular "petitioner" refers to the parent corporation, The Boeing Company. Under the method used by petitioner, the transfer price is the price that would allow the DISC to derive taxable income attributable to the sale of the property in an amount that does not exceed "50 percent of the combined taxable income of such DISC and [the parent related supplier] which is attributable to the qualified export receipts on such property derived as a result of the sale by the DISC." 26 U.S.C. 994(a)(2). See H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971); S. Rep. No. 437, *supra*, at 107. The cognate rule for a FSC is found in Section 925(a)(2), which sets the limit at 23 percent of CTI.

income on a ratable basis." H.R. Rep. No. 533, *supra*, at 74; S. Rep. No. 437, *supra*, at 107-108.

Section 861, to which the DISC committee reports refer, serves to distinguish between domestic and foreign source income for income tax purposes. The determination of the domestic or foreign source of the income has importance for many purposes. See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.02, at 17-4 to 17-27 (5th ed. 1987). Section 861(a) specifies a number of broad categories of gross income (such as interest from United States payers) that are treated as United States sources income. Section 861(b) provides, in turn, that expenses "properly apportioned or allocated" to the items of gross income specified in Section 861(a), along with a ratable portion of any expense that "cannot definitely be allocated" to an item of gross income, shall be deducted to arrive at taxable income. 26 U.S.C. 861(b). The key determination made under Section 861(b) is thus whether an expense is "properly apportioned or allocated" to an item of gross income. Congress did not define the statutory phrase that provides for expenses "properly apportioned or allocated" against various types of income, and taxpayers therefore look to Treasury regulations for guidance.

d. The Treasury regulations adopted to implement the DISC provisions tracked the congressional committee reports. 26 C.F.R. 1.994-1(c)(6) provides that CTI from a sale of export property "is the excess of the gross receipts (as defined in Section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such receipts." Section 1.994-1(c)(6)(iii), in turn, defines the costs that are treated as relating to those gross receipts as (emphasis added):

> (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, *determined in a manner consistent with the rules set forth in § 1.861-8.*

The DISC regulations thus specifically incorporate the regulations issued under Section 861. Those regulations were promulgated in 1977 "principally to ensure that foreign operations of domestic corporations are charged with a proper share of deductions." B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 70.10.1, at S70-26 (Supp. 1999). Expenses, losses and other deductions are to be allocated to the class of gross income to which they are definitely related (26 C.F.R. 1.861-8(b)(1)) and then apportioned, if necessary, between so-called "statutory groupings" and "residual groupings" (26 C.F.R. 1.861-8(c)(1)).[6] The deductions that are related to all of a taxpayer's gross income or that are not definitely related to any class of gross income are ratably apportioned to all gross income. 26 C.F.R. 1.861-8(b)(5) and (c)(2).

The regulations under Section 861 recognized "that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development." 26 C.F.R.

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[6] The computation of DISC taxable income was treated as a "statutory grouping" for these purposes. 26 C.F.R. 1.861-8(f)(1)(iii). The same is true of FSC taxable income. *Ibid.*

1.861-8(e)(3)(i)(A) (1979).[7] Consequently, research and development expenses were "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)." *Ibid.* These regulations originally used the two-digit categories found in the Standard Industrial Classification Manual published by the Office of Management and Budget as the relevant product categories. *Ibid.* When these regulations were revised in 1995, however, the narrower three-digit standard industrial classification codes were adopted as the relevant product categories for this purpose. 26 C.F.R. 1.861-17(a)(2)(ii). See T.D. 8646, 1996-1 C.B. 145.

3. a. Petitioner, along with its DISC (Boeing International Sales Corporation) and its FSC (Boeing Sales Corporation), chose to group its export sales according to petitioner's internally designated "Airplane Programs" and to use the combined taxable income method for each grouping. Invoking 26 C.F.R. 1.994-1(c)(7) (DISC) and 26 C.F.R. 1.925(a)-1T(c)(8)(ii) (FSC), petitioner treated each of its programs as a product line and computed the CTI for each program. Pet. App. 2a-3a. In doing so, however, petitioner declined to follow the requirement of the regulations that research and development expenses be allocated on the basis of the (then) two-digit industrial classification codes required by 26 C.F.R. 1.861-8(e)(3)(i)(A) (1979). Instead, petitioner sought to allocate most of its research and development expenses along narrower, airplane-by-airplane product lines. Pet. App. 3a. The result of the narrower allocation method followed by petitioner would be to reduce the research and development expenses allocated to its export sales and thereby increase the "combined taxable income" from those sales and decrease the resulting United States taxes owed by petitioner during the relevant years. *Id.* at 3a-4a.

[7] In December 1995, the research and development provisions previously published as 26 C.F.R. 1.861-8(e)(3) (1979) were amended and renumbered as 26 C.F.R. 1.861-17.

b. Petitioner organized its operations in defined operating divisions that dealt with specific products or services and operated largely autonomously. Petitioner's largest division was its Commercial Airplane Division, which produced different models of commercial airplanes and related products and provided related services. The Commercial Airplane Division was, in turn, divided for purposes of organization and accounting into programs dealing with a specific airplane model or with spares, sundry or other activities. Petitioner's financial statements generally did not break down revenues or profits by programs. Instead, they were reported in total for the Commercial Airplane Division. Pet. App. 2a.

Petitioner divided its R&D expenditures into two categories: "Blue Sky R&D" and "Company Sponsored Product Development." Of the approximately $4.6 billion in R&D expenditures incurred by petitioner during the relevant years, approximately $1.0 billion was classified as Blue Sky R&D and $3.6 billion was classified as Company Sponsored Product Development. Pet. App. 2a-3a; C.A. E.R. 4-5.

Blue Sky R&D involved basic airplane technology, as well as the development of new airplanes prior to the initiation of specific airplane programs. A large amount of petitioner's Blue Sky R&D expenses were incurred in "informal programs" or "projects" that were the pre-

cursors to specific formally identified programs. For example, petitioner incurred significant Blue Sky R&D expenditures related to what petitioner referred to as the 7X7 "Program" or "Project" and which eventually became the 767 Program when petitioner's Board of Directors authorized the "program go-ahead." Pet. App. 3a, 17a; C.A. E.R. 62-63, 102.[8]

Company Sponsored Product Development represented research and development expenditures that petitioner identified with particular airplane programs. The difference between Blue Sky R&D and Company Sponsored Product Development was a function of the way petitioner divided its commercial airplane business for cost accounting and management purposes. Under petitioner's system, an "airplane program" designated the organizational component that developed and manufactured a specific airplane model after that model had achieved "program go-ahead" status. See note 8, *supra*. During the tax years at issue in this case, petitioner established or maintained a separate program for each of the following airplane models: 707, 727, 737, 737-300, 747, 757 and 767. Pet. App. 16a; C.A. E.R. 4.

c. In computing CTI, petitioner annually allocated its Blue Sky R&D costs among all of its airplane programs primarily on the basis of the number of direct labor hours incurred in each program. Pet. App. 3a; C.A. E.R. 157. Petitioner allocated Company Sponsored Product Development research to the particular program for which it was incurred. Each year petitioner made these allocations to a particular airplane program even though there might be no sales in that program for that year. As a result, under petitioner's method of allocating R&D expenses, approximately $1.9 billion dollars of R&D expenditures during the years in question—expenditures that were deducted from the income earned by petitioner's Commercial Airplane Division in determining its taxable income generally—were *not* deducted in computing the CTI for sales through Boeing International Sales Corporation and Boeing Sales Corporation for purposes of the DISC and FSC provisions. Pet. App. 3a; C.A. E.R. 152-153. The result was to increase the amount of tax exempt or tax deferred income treated favorably under the DISC and FSC provisions.

d. On audit, the Internal Revenue Service rejected petitioner's methods of allocating R&D expenses in computing the CTI from DISC and FSC sales of its commercial airplanes and related products and services and recomputed the CTI from those sales by allocating the R&D expenses in accordance with 26 C.F.R. 1.861-8(e)(3) (1979). The Service thus allocated petitioner's R&D expenses (both Blue Sky R&D and Company Sponsored Product Development R&D) to all of petitioner's income from sales of commercial airplanes and related products and services in a single category under the two-digit Standard Industrial Classification Code 37 (Transportation Equipment) and apportioned those R&D expenses among petitioner's programs on the basis of sales in each program. This reallocation of R&D expenses resulted in more expenses being allocated to petitioner's qualified export sales, thereby decreasing the CTI for those sales under the DISC and FSC provisions, and thereby yielding a greater tax

[8] Program go-ahead was the point at which petitioner's Board of Directors made a firm commitment to produce a particular airplane model. That decision was contingent, in part, on the existence of a significant number of firm customer orders for that airplane model. Pet. App. 3a, 17a; C.A. E.R. 105-106, 115-116.

liability for each of the years in question. Pet. App. 3a-4a, 18a.

4. Petitioners paid the additional tax and filed timely claims for refund. After those claims were not granted, petitioners filed this suit for refund in the United States District Court for the Western District of Washington. Pet. App. 4a. Petitioners contended that the application of 26 C.F.R. 1.861-8(e)(3) (1979) to CTI calculations was "arbitrary, capricious, and invalid under the Code sections and regulations governing DISC and FSC export transactions." C.A. E.R. 8.

The district court upheld petitioner's contention. Pet. App. 24a. The court concluded that there is a conflict between the two-digit Standard Industrial Classification Code product categories mandated by 26 C.F.R. 1.861-8(e)(3) (1979) and the statement in the DISC regulation that a taxpayer's grouping of transactions is "controlling" (26 C.F.R. 1.994-1(c)(6)(iv)) in the allocation of deductions against the gross income resulting from such grouping. Pet. App. 21a. In so ruling, the court followed the decision of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), which had concluded that 26 C.F.R. 1.861-8(e)(3) is invalid as applied to DISC computations. The district court stated that the court in *St. Jude* had identified three "defects" in the application of 26 C.F.R. 1.861-8(e)(3) to DISC transactions, two of which were present here. Pet. App. 21a. First, the court stated that the two-digit Standard Industrial Classification Code grouping of 26 C.F.R. 1.861-8(e)(3) departs from the legislative intent to allow costs "to be allocated on a product-by-product basis or on the basis of product lines" when computing CTI. Pet. App. 21a-22a. Second, the court stated that the two-digit industrial code grouping required by 26 C.F.R. 1.861-8(e)(3) is

inconsistent with a legislative intent to allocate to each product group "all expenses *directly related*" to the exported goods. Pet. App. 22a (quoting *St. Jude*, 34 F.3d at 1401). The district court therefore concluded that the regulatory requirements of 26 C.F.R. 1.861-8(e)(3)(ii) (1979) are inapplicable to the calculation of CTI and entered judgment in favor of petitioners and against the government for $419,110,539 in tax and assessed interest. Pet. App. 4a.[9]

5. The court of appeals reversed. Pet. App. 1a-14a. Declining to follow the reasoning or holding of *St. Jude*, the court of appeals agreed with the government that 26 C.F.R. 1.861-8(e)(3) provides the appropriate method for allocating R&D expenses in calculating CTI under the DISC and FSC provisions. Pet. App. 10a-11a. The court noted that, under the plain text of Section 994(a)(2), "CTI is to be calculated based on revenue and costs 'attributable to' sales in the applicable year * * * [and the statute] does not confine the relevant costs to those 'definitely related' to sales of a particular product." *Id.* at 11a. The court concluded that the legislative history of the statute requires the same conclusion (*ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74)):

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[9] Because the decision of the district court resulted in a correlative increase in the taxable income of petitioner's FSC, the court also awarded the government a judgment of $481,149 against Boeing Sales Corporation. See *United States* v. *Boeing Sales Corp.*, No. 01-1382 (Mar. 20, 2000), Cond. Cross Pet. at 3. Boeing Sales Corporation therefore filed a conditional cross-appeal. Because both sides agreed that the judgment against Boeing Sales Corporation was a computational function of the judgment in favor of petitioner and should be reversed if the principal judgment were reversed, the conditional cross-appeal was not separately briefed. Appellee's Br. 17 n.8; Appellant's Reply Br. 1 n.1.

> This House Report reflects that Congress recognized some of the costs incurred in a given tax year would not be "directly related" to specific income items. The Report further reflects Congress's intention that those costs not "directly related" would be allocated to export-related sales on a pro rata basis. The Commissioner's interpretation of [26 C.F.R.] 1.861-8(e)(3) effectuates this Congressional intent.

The court of appeals disagreed with the district court on whether there was a conflict between the requirements of 26 C.F.R. 1.861-8(e)(3) and 26 C.F.R. 1.994-1(c)(6). The court of appeals emphasized that the DISC statute and its legislative history contemplate that the "total costs" allocable to export sales were to include both "definitely" and "indefinitely" related costs, which the court equated with "direct" and "indirect" costs. Pet. App. 12a. Noting that no actual conflict exists in the text of 26 C.F.R. 1.861-8(e)(3) and 26 C.F.R. 1.994-1(c)(7), the court concluded that these regulations "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in [26 C.F.R.] 1.861-8(e)(3)." Pet. App. 12a. The court concluded that petitioner's alternative method of allocating R&D costs for purposes of the DISC and FSC provisions was invalid because it fails to allocate the "total costs" of export sales in computing CTI. *Id.* at 6a.

ARGUMENT

1. As a consequence of the various revisions and repeals of the pertinent statutory provisions, the specific issues presented in this case under the separate DISC and FSC tax regimes lack meaningful prospective importance. For the reasons set forth in detail at pages 2-3, *supra*, the interpretation of the DISC statute and regulations has no prospective importance (i) because that statute is not available for large exporters (such as petitioner) and (ii) because the features of the DISC that were determined to represent a prohibited export subsidy under the GATT were removed by Congress in 1984 and the statute thus no longer provides significant tax relief even for small exporters. Similarly, the proper construction of the separate FSC statute and regulations lacks prospective importance because it has relevance only for the few taxpayers who, following enactment of the ETI, claim reliance on the narrow transitional FSC rules. See pages 3-5, *supra*. And, regulations under the ETI have not yet been formalized and issued for public comment.[10] The questions presented in the petition therefore lack recurring importance and do not warrant review by this Court.

2. a. For the reasons carefully detailed in the decision below (Pet. App. 10a-13a), the court of appeals

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[10] In the legislative history of the ETI, Congress emphasized its intention that, for the common case involving foreign trade transactions, both related direct expenses and overhead expenses apportioned in a reasonable manner are to be taken into account. See H.R. Conf. Rep. No. 1004, 106th Cong., 2d Sess. 199-202 (2000). Rules promulgated under the ETI could therefore reasonably address, and remove, the asserted "conflict" in the regulations that was the premise for the decision of the court of appeals in the *St. Jude* case. See page 14, *infra*.

correctly concluded that, in determining "combined taxable income" for DISC and FSC transactions during the years relevant to this case, R&D expenses were to be grouped under the two-digit SIC codes required by 26 C.F.R. 1.861-8(e)(3) (1979). See also note 11, *infra*. Although the decision of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394, 1396-1402 (1994), conflicts with that determination as applied to DISC transactions only, there is no recurring importance to that conflict because the pertinent provisions of the DISC statute have been modified or repealed. See pages 2-3, *supra*.

b. There is no conflict among the circuits concerning the further determination of the court of appeals in this case that the agency's regulations provide a proper allocation of R&D expenses to FSC transactions. Indeed, this is the first appellate decision even to address that issue. The FSC statute and regulations present this expense-allocation question in a distinctly different context than was before the court in *St. Jude*, which addressed only the materially different DISC provisions. See 34 F.3d at 1396-1402.

The DISC regulations involved in *St. Jude* specified "that the *taxpayer's choice regarding the grouping of transactions shall control* as long as it conforms to a recognized industry/trade usage or a SIC group." 34 F.3d at 1402 (emphasis added) (citing 26 C.F.R. 1.994-1(c)(6)(iv), (7)(ii)). The court in *St. Jude* concluded that this regulation required the Treasury to respect the grouping chosen by the taxpayer in allocating R&D expenses in making CTI calculations under the DISC regime, rather than the two-digit SIC classification code grouping specified in the Section 861 regulations. The court emphasized that the Section 861 regulations were not adopted with DISCs specifically in mind and

that, "at the time the DISC legislation was enacted, [the Section 861 regulations] did not contain the SIC categories * * * ." 34 F.3d at 1402. The court concluded in *St. Jude* that, because the two-digit SIC classification code allocation procedures of the Section 861 regulations were adopted after the DISC legislation was enacted, they should not be "applied to DISC CTI computations." *Ibid.*[11]

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[11] For reasons similar to those adopted by the court of appeals in this case (see Pet. App. 10a-13a), the Tax Court in *St. Jude* also rejected the assertion that there is a conflict between the DISC regulations and the Section 861 regulations. *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. 457, 479-481 (1991), aff'd in part and rev'd in part, 34 F.3d 1394 (8th Cir. 1994). The Tax Court emphasized that the cost allocation methods established in the Section 861 regulations are entitled to substantial judicial deference. 97 T.C. at 483. Section 863 of the Code expressly authorizes the Secretary of the Treasury to prescribe regulations under Section 861 to specify how items of income, expense, and losses and deductions are to be allocated or apportioned to sources within or without the United States (26 U.S.C. 863(a)), and the regulations adopted under this statute are to be upheld when, as here, they provide a reasonable choice among alternative methods of implementing the statute. 97 T.C. at 483. As this Court held in *United States* v. *Correll*, 389 U.S. 299, 307 (1967):

> In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Commissioner* v. *Stidger*, 386 U.S. 287, 296. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

The Tax Court also noted the Section 861 regulations "harmonize[] with the origin and purposes of" the DISC provisions. 97 T.C. at 483. The DISC committee reports state that "the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable

The reasoning of the court of appeals in *St. Jude*, however, has no application to CTI calculations under the separate FSC statute and regulations. In the first place, by the time Congress enacted the FSC provisions in 1984, the Section 861 regulations for R&D expense allocations in CTI calculations had long been in place. 26 C.F.R. 1.861-8(e)(3) (1979). And, when the FSC was enacted, Congress specifically endorsed application of the then-existing Section 861 regulations to the new FSC regime. 1 Staff of the Sen. Comm. on Finance, 98th Cong., 2d Sess, *Deficit Reduction Act of 1984*, at 636 (Comm. Print 1984). See also H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 968-977 (1984).[12]

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under section 861 * * * [which] generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." H.R. No. 533, *supra*, at 74; S. Rep. No. 437, *supra*, at 107-108. Contrary to petitioners' assertion (Pet. 17-19), nothing in the Section 861 regulations conflicts with this legislative description of those regulations. The Section 861 regulations apportion items of expense partially on a direct and partially on a ratable basis. See 26 C.F.R. 1.861-8(a)(2) (1979) ("allocations and apportionments are made on the basis of the factual relationship of deductions to gross income"). The regulations thus recognize a fundamental tenet of cost accounting, which is that "the unit of costing determines whether a cost is direct or indirect: as the unit of costing changes, some indirect costs may be converted to direct costs." D. Keller et al., *Management Accountants' Handbook* ¶ 7.2(b), at 7-8 (4th ed. 1992).

[12] Beginning with the Economic Recovery Tax Act of 1981, § 223, Pub. L. No. 97-34, 95 Stat. 249, Congress enacted a series of moratoriums on 26 C.F.R. 1.861-8(e)(3) (1979) for geographic source purposes under Section 904 of the Code. Those moratoriums, however, did not apply to CTI calculations under either the DISC or FSC provisions. See *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 983 (9th Cir. 1996); *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d at 1403-1405. Congress thus specifically contemplated that the Section 861 regulations (including the two-digit SIC classification code grouping requirement) were to apply to FSC CTI determinations.

Secondly, when the FSC regulations were adopted, they did not employ the language from the DISC regulations on which the court relied in the *St. Jude* case. While the DISC regulations had stated that the grouping election of the DISC and its parent would be "controlling" (26 C.F.R. 1.994-1(c)(7) (1979)) and that the "costs deductible in a taxable year [were to] be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping" (26 C.F.R. 1.994-1(c)(6)(iv)), the regulations adopted to implement the FSC regime contained no parallel provision. See 26 C.F.R. 1.925-1T(c)(6) (1989). The regulatory language on which the court of appeals relied in *St. Jude* in concluding that a conflict existed between the grouping directives of the DISC regulations and the Section 861 regulations thus did not exist under the FSC regime. Instead, under the FSC regime, both the Section 861 regulations and the FSC regulations direct the taxpayer to recognized trade usages and the "two-digit major groups * * * of the Standard Industrial Classification" codes in allocating expenses among groups of products. 26 C.F.R. 1.925(a)-1T(c)(8)(ii) (1989); see 26 C.F.R. 1.861-8(e)(3) (1979). Since the *St. Jude* case concerned DISC transactions only, that court did not have the FSC provisions before it. And, since the reasoning of the *St. Jude* court concerning the DISC provisions is inapplicable to the different statutory and regulatory provisions governing the taxation of FSC transactions, there is no conflict between that decision and the holding in this case that the two-digit

SIC codes properly apply in allocating expenses among FSC product lines.

Moreover, in the course of generally revising the Section 861 regulations in 1995, the Treasury adopted a more specific product grouping provision that now directs the allocation of R&D expenditures on the basis of "the three digit classification of the Standard Industrial Classification Manual (SIC code)." 26 C.F.R. 1.861-17(a)(2)(ii). That more recent regulatory definition of product groups makes the controversy raised by petitioner in this case even more remote for the future.

In any event, the FSC provisions were repealed in 2000 and replaced by the ETI. See pages 3-5, *supra*. Because there is no relevant, current conflict among the circuits concerning the present application of either the FSC or the ETI, and since the DISC has no genuine present application for export transactions, there is no probable future importance to the issues addressed in this case. Further review of the extremely narrow, technical questions presented by the petition is therefore not warranted.

3. Petitioner errs in contending that the straightforward application of the longstanding Treasury regulations adopted by the court of appeals in this case achieves a "perverse result" (Pet. 16). The difference between the R&D expense allocation requirements of the Section 861 regulations and the model-by-model allocation proposal of petitioner is not just one of timing. Although petitioner suggests that "[t]here is nothing inherently wrong in having the costs directly related to a particular product line exceed the gross income generated by that line in a given year" (Pet. 22), this obscures the fact that, under petitioner's interpretation, such excess costs would *never* be deducted from gross income generated in a later year. Petitioner's

contention is that, in calculating its CTI, it should be allowed to ignore nearly $2 billion in aircraft R&D expenses because the income from some of the applications of that research was not realized in the tax years that the expenses were incurred. Petitioner's interpretation would improperly overstate its "combined taxable income" from export sales of aircraft (and thereby reduce its United States taxes) by violating the requirement that "the *total costs* of the DISC and related supplier which relate to such gross receipts" be deducted in computing CTI. 26 C.F.R. 1.994-1(c)(6) (emphasis added). See also 26 C.F.R. 1.925(a)-1T(c)(6) (1989).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations set forth in the appendix to the petition, the following statutes and regulations are involved in this case.

1. During the years relevant to this case, 26 U.S.C. 925 (1985) (added by Pub. L. No. 98-369, Div. A, tit. VIII, § 801(a), 98 Stat. 990), provided, in relevant part:

> (a) In general.—In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—
>
> (1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,
>
> (2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or
>
> (3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).
>
> Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

(b) Rules for commissions, rentals, and marginal costing.—The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

(c) Requirements for use of administrative pricing rules.—A sale by a FSC meets the requirements of this subsection if—

(1) all of the activities described in section 924(e) attributable to such sale, and

(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale,

have been performed by such FSC (or by another person acting under a contract with such FSC).

(d) Limitation on gross receipts pricing rule.—The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the amount which would be determined under subsection (a)(2) with respect to such transaction.

(e) Taxable income.—For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

(f) Special rule for cooperatives.—In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

2. 26 C.F.R. § 1.925(a)-1T (1989) provided, in relevant part:

Temporary regulations; transfer pricing rules for FSCs.

* * * * *

(c)(6) *Full costing combined taxable income*—(i) *In gen eral.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of § 1.482-2(b) (1) through (6). Section 1.482-2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (i.e., the related supplier) or the member receiving the benefit of the services (i.e., the FSC), shall not apply if the administrative pricing methods of section 925(a) (1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482-2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See § 1.925(a)-1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs.* In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii) (A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii) (B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) *Cooperatives and combined taxable income method.* If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382(b) and (c) for patronage dividends, per-unit retain allocations and nonpatronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) [Reserved]. For further guidance, see § 1.925(a)-1(c)(8)(i).

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof,

within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and § 1.923-1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general

grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923(a)(4) increases the amount of the FSC's exempt foreign trade income with regard to sales of these products, see § 1.923-1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see § 1.924(d)-1(e)).

* * * * *

(g) *Effective date.* The provisions of this section and § 1.925 (b)-1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

3. Since December 22, 1995, 26 C.F.R. § 1.861-17 has provided (T.D. 8646, 60 FR 66503 (Dec. 22, 1995)):

§ 1.861-17 Allocation and apportionment of research and experimental expenditures.

(a) *Allocation*—(1) *In general.* The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or

categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) *Product categories.*—(i) *Allocation based on product categories.* Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) *Use of three digit standard industrial classification codes.* A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) *Consistency.* Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer,

it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

* * * * *

Supreme Court, U.S.
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No. 01-1209

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR THE PETITIONERS

At the heart of this case is a circuit split involving a significant and continuing issue affecting the application of federal export incentive statutes aimed at leveling the playing field for U.S. exporters vis-à-vis their foreign competitors. This federal tax legislation, enacted in three successive iterations, has been in effect for 30 years, and affects significant numbers of this country's largest corporations and leading exporters.[1]

The Eighth and Ninth Circuits have issued conflicting decisions regarding which of two contradictory expense allocation provisions of the Treasury Regulations applies in the context of the export incentive provisions. The government concedes that this circuit conflict exists. However, the government attempts to diminish the importance of the circuit split by erroneously asserting that the conflict disappeared with the enactment of the FSC provisions. In fact, an analysis of the regulations shows that, as the government stipulated and the Ninth Circuit recognized below, the relevant DISC and FSC provisions are substantively the same. Thus, the conflict continues into the FSC years. Furthermore, because ETI, the third iteration of the export provisions, contains essentially the same provisions, the issue remains important into the future.

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[1] As explained in more detail in the petition, the original provisions adopted in 1971 provided export incentives through the use of Domestic International Sales Corporations (DISCs). I.R.C. §§ 991-997. In 1984, the DISC regime was replaced with the Foreign Sales Corporation (FSC) provisions of sections 921-927. In 2000, the FSC regime was replaced with the Extraterritorial Income Exclusion (ETI) regime. I.R.C. §§ 114, 941-943. Unless otherwise noted herein, all Code and section references are to the Internal Revenue Code of 1954 or 1986, as amended and in effect during the relevant time periods, and the Treasury regulations thereunder.

The export incentive provisions involved in this case provide that, in making the relevant income calculations, taxpayers must deduct R&D expenses that are directly related to a given product category *only* from income generated by that product category. For this purpose, taxpayers are allowed to choose to group their products by product line either according to recognized industry or trade usage or by SIC code, and the taxpayer's choice of such product line grouping "will be accepted" by the Internal Revenue Service (IRS).

The decision below effectively supplants these rules by *requiring* taxpayers to allocate R&D expenses by grouping products only by SIC code, thereby forcing them to allocate R&D directly related to certain product lines to other product lines to which they are not related. Significantly, the government makes virtually no attempt to defend the Ninth Circuit's erroneous reasoning that leads to this perverse result.

The Ninth Circuit's decision undermines the national export incentives embodied in the DISC provisions. It also subverts the uniform application of the federal income tax laws, creating a situation in which taxpayers in two circuits would be taxed differently based solely on the locations of their headquarters. In addition, as the *amici curiae* explain, taxpayers in other circuits now face uncertainty as to which of the two conflicting expense allocation regulations takes precedence in applying the federal export incentive provisions. Billions of dollars over many years – past, present and future – potentially are at stake in this case. Review by this Court is therefore imperative.

A. There is a Direct Circuit Split of Ongoing Importance.

1. The government concedes that a circuit conflict exists with respect to the DISC provisions affecting the majority of Boeing's taxable years at issue in this case. Br. in Opp. 18. The Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), concluded that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the calculation of combined

taxable income (CTI) under the DISC provisions. The Ninth Circuit specifically "decline[d] to follow the reasoning of *St. Jude Medical*" (Pet. App. 10a), and upheld the application of Treas. Reg. § 1.861-8(e)(3) to the computation of CTI for purposes of the DISC and FSC provisions.

In a startling turnabout, however, the government denies that a conflict exists with respect to the FSC provisions, claiming that the FSC provisions are "materially different" from the DISC provisions. Br. in Opp. 18. This transparent attempt to diminish the importance of the circuit split is contrary to the government's previous stipulation, positions in its briefs, and published statements. The parties long ago correctly agreed that "[a]lthough there are some differences between the DISC and FSC rules, *none of them relate to th[e] issue in this case*." Stip. ¶ 28 (emphasis added). Moreover, the government has acknowledged that "[a]lthough there are * * * differences between the DISC and the FSC rules, none of them relates to the issue in this appeal, which is common both to DISCs and FSCs. * * * *[W]hat we say about a DISC will be analogously true of a FSC.*" U.S. 9th Cir. Br. 22 (emphasis added).[2] And in its published Action on Decision stating that it would not acquiesce in *St. Jude Medical*, the government announced that "this issue should continue to be litigated and/or defended since it also arises in the context of Foreign Sales Corporations." AOD 1999-005 (Aug. 30, 1999). Concurring in the government's longstanding position that the issue is identical under both DISC and FSC, the Ninth Circuit concluded that "the differences between these statutory schemes are not relevant to this appeal." Pet. App. 6a n.3. The Ninth Circuit did not, of course, make any attempt to distinguish *St Jude Medical* on this basis.

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[2] The district court confirmed that "[a]lthough there are some differences between the DISC and FSC provisions, the parties agree that the calculation of the CTI on export sales is essentially the same for both." Pet. App. 20a n.2.

The government attempts to justify its reversal of position by pointing to the absence from the FSC regulations of redundant language from the DISC regulations that provided that the taxpayer's choice of grouping is "controlling" and that costs shall "be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping." Br. in Opp. 21. This argument is frivolous. An analysis of the export incentive regulations confirms that the relevant provisions have remained substantively unchanged for nearly 30 years. These provisions consistently establish (a) that expenses directly related to a product group may be allocated only to that group, and (b) that taxpayers may choose to allocate expenses on the basis of product lines grouped either by recognized industry or trade usage or by SIC code, and a taxpayer's choice binds the IRS.

The DISC and FSC regulations *both* provide that, for purposes of calculating CTI, "expenses * * * definitely related" to export property and "a ratable part of any other expenses * * * which are not definitely related" thereto must be allocated to income from such property. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). *Both* regulations allow taxpayers to make these computations "on a transaction-by-transaction basis" or "on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i); Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i).[3] Under

[3] The government notably omits this important provision of the FSC regulations from its appendix, thereby leaving the impression that this key provision of the FSC regulations vanished by 1989. That is not so. The "1989" version of the FSC regulation (Temp. Treas. Reg. § 1.925(a)-1T(c)(8)) reproduced in the government's appendix (Br. in Opp. App. 3a, 6a) is actually that regulation after an amendment in *2001*. See Grouping Rules for Foreign Sales Corporation Transfer Pricing, 66 Fed. Reg. 13,427 (Mar. 6, 2001). The 2001 amendment simply moved the product grouping language quoted in the above text from the *temporary* FSC regulations to the *final* FSC regulations (Treas. Reg. §1.925(a)-1(c)(8)(i)). Thus, that language remains fully operative today. In fact, it has been part of the export incentive regulations continuously from their inception.

both regimes, this taxpayer election "will be accepted" by the IRS if the determination is based on either "recognized industry or trade usage" *or* two-digit SIC code. Treas. Reg. § 1.994-1(c)(7)(ii)(a); Temp Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

The language of *both* the DISC and the FSC regulations therefore squarely conflicts with Treas. Reg. § 1.861-8(e)(3), which requires taxpayers to group their transactions *solely* by SIC codes. Accordingly, because the courts of appeals are in conflict with regard to the DISC issue (as the government concedes), a conflict necessarily exists with regard to the FSC issue. Review by this Court is therefore required to resolve a clear and irreconcilable dispute between the courts of appeals on this significant issue of federal law.

2. The government argues that this case has no prospective importance because the future application of DISC and FSC has been restricted, and no regulations exist under the current iteration of the export incentive regime, ETI. Here, too, the government is plainly wrong. Indeed, ETI so closely parallels FSC (and therefore DISC) that Congress has specified that all relevant FSC regulations continue to apply for ETI purposes; indeed, Congress's directive refers *specifically* to the FSC grouping regulations.[4] Thus, under ETI, as under DISC and FSC, the taxpayer's choice of grouping "will be accepted." Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). As was clearly stated in the ETI Conference Report, "[u]nder the grouping method, the conferees intend that *taxpayers be given reasonable flexibility to identify product lines or groups* on the basis of *recognized industry or trade usage*." H.R. CONF. REP. NO. 1004, 106th Cong., 2d Sess. 195 (2000) (emphasis added). Accordingly, the issue in this case remains as important as ever.

[4] H.R. CONF. REP. NO. 1004, 106th Cong., 2d Sess. 207 (2000).

The government asserts that "[r]ules promulgated under the ETI could * * * reasonably address, and remove, the asserted 'conflict' in the regulations that was the premise for the decision of the court of appeals in the *St. Jude* case." Br. in Opp. 17 n.10. It is *always* possible that a regulation could change in the future. But that mere possibility is no reason to deny certiorari. The government does not represent that any such change has been made or even proposed.

3. The conflict between the Eighth and Ninth Circuits leaves the tax law in turmoil. Without resolution of this conflict, taxpayers in the Ninth Circuit will be forced to apply a far more costly expense allocation regulation than taxpayers in the Eighth Circuit, including, in some cases, their competitors.[5] Taxpayers outside these two circuits will be left without clear judicial guidance on how to apply the export incentive provisions.

The government attempts to dismiss the issues in this case as "extremely narrow, technical questions" of little relevance. Br. in Opp. 22. This self-serving assertion ignores the widespread use and importance of the export provisions. As is evidenced by the filing of the *amici curiae* briefs in this case, the issue is of enormous significance to many taxpayers.[6] The IRS is still auditing many companies for tax years to which the

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[5] The significance of this potential competitive disadvantage can be seen by the dollar amount at issue in this case for just one taxpayer over a nine-year period (over $400 million).

[6] As noted in the *amici* briefs submitted in support of the petition, other taxpayers affected by the DISC and FSC regulations include such large corporations as General Electric, Intel, Microsoft, Brunswick, Hewlett-Packard, Reebok, Union Carbide, General Dynamics, Oracle, Caterpillar Tractor, KLA-Tencor, Dresser Industries, and St. Jude Medical. TEI Am. Br. 9-10; Brunswick, et al. Am. Br. 1-5. It has been estimated that aggregate annual tax benefits from the FSC regime for the year 2000 alone will be $4 billion. Pet. 24.

DISC and/or FSC provisions apply.[7] In addition, many corporations with open statutes of limitations are eligible to file claims for refunds of income taxes paid during DISC and/or FSC years. Perhaps most significant of all, the existing uncertainty undermines ETI's purpose of stimulating American exports into the future.

B. Review by this Court is Needed Because the Holding of the Ninth Circuit is Wrong.

The government makes virtually no attempt to defend or rely on the reasoning of the court of appeals whose judgment it seeks to sustain. Little could betray the weakness of the Ninth Circuit's opinion more tellingly.

The Ninth Circuit's mandatory application of the § 1.861-8(e)(3) allocation rule would force taxpayers to allocate R&D strictly by two- or three-digit SIC code product groups, thereby causing R&D expenses completely unrelated to export income nevertheless to be allocated to that income. That result simply writes out of the export regime's regulations the provision authorizing all expense allocations to be made by recognized industry or trade usage product groupings.[8] By the same token, the opinion also effectively writes out of the export regulations the mandate that expenses "directly related" to export property be allocated *only* to that export property. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D).

The government claims that Boeing's method of allocation "violat[es] the requirement that 'the *total costs* of the DISC and related supplier which relate to such gross receipts' be deducted

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[7] See TEI Am. Br. 9.

[8] It is undisputed that Boeing's product line groups were in accordance with recognized industry or trade usage. Pet. App. 2a, 16a. Moreover, Boeing adopted its accounting methods for internal management reporting purposes well before any of the export incentives were enacted.

in computing CTI." Br. in Opp. 23 (emphasis in original). But the regulations clearly state that only the total costs that *relate to* gross receipts must be deducted. This general mandate is carried out by the specific requirement that those costs "definitely related" to a product group can be attributed only to that product group. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). The regulations leave no room for taking a portion of the expenses that *are* in fact related to a particular class of export property and apportioning them to other, *unrelated* property. Yet that is exactly what the Ninth Circuit's rule would require.

A strict mandate to allocate expenses solely by SIC code would force taxpayers to allocate expenses to products to which those expenses bear absolutely no relation and would lead to absurd results. For example, bicycles and motor scooters are in the same 2-digit SIC code as Boeing's aircraft (SIC code 37 "Transportation Equipment"). The Ninth Circuit's holding would thus require a taxpayer to allocate R&D expenses relating to a nascent or failed airplane development program to income from the sales of bicycles.

The government argues that the likelihood of such an irrational allocation will be "more remote" because a 1995 amendment changed the SIC code reference in Treas. Reg. § 1.861-8(e)(3) from 2-digit SIC codes to 3-digit SIC codes (Br. in Opp. 22). In fact, precisely the same problem arises with reference to 3-digit SIC codes. Hang gliders, balloons, and blimps are in the same 3-digit SIC code as Boeing's aircraft (SIC code 372, "Aircraft and Parts"). It simply makes no sense to allocate the R&D expenses incurred to develop a jet fighter to the income from hang gliders, any more than it makes sense to allocate expenses incurred in the development of a mainframe computer to the income from pencil sharpeners or staple removers (all within the same 3-digit SIC code 357, "Computer and office equipment").

Notably, the issue that arose in *St. Jude Medical* would not be any different had the case been decided after the post-1995 section 861 regulations were in place. That case involved three medical products (insulin pumps, pacemakers, and prosthetic heart valves) within the same 2-digit SIC code. The same 3-digit SIC code (SIC code 384, "Surgical, Medical, and Dental Instruments") still encompasses all three products. It also includes such disparate items as corneal microscopes, heart-lung machines, ultrasound equipment, cotton balls, artificial limbs, crutches, whirlpool baths, wheelchairs, operating tables, and space suits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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IN THE

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the the United States Court of Appeals for the Ninth Circuit

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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IN THE

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v.

UNITED STATES OF AMERICA,
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On Petition for a Writ of Certiorari to the the United States Court of Appeals for the Ninth Circuit

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the Petition for a Writ of Certiorari filed by Boeing Company and its subsidiaries.[1] Tax Executives Institute ("TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, its members' companies, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioners and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and has approximately 5,300 members who represent more than 2,700 of the leading businesses in the United States, Canada, and Europe. The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers.

Members of the Institute have a vital interest in this case, which involves the resolution of a sharp conflict concerning the interpretation of tax statutes affecting the foreign commerce of the United States. The substantive issue in the case is whether Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of research and development expenses) should override the intended operation of the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code. Eight years ago, the U.S. Court of Appeals for the Eighth Circuit held in *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394 (1994), that the Treasury Regulation is invalid in this context, noting that the mandated allocation method is inconsistent with Congress's intent to allocate costs to definitely related gross receipts. In the instant case, the U.S. Court of Appeals for the Ninth Circuit declined to follow *St. Jude Medical* and held instead that the regulation is valid.

By creating a split in the circuits, the Ninth Circuit's decision robs taxpayers of needed certainty about the proper allocation of research and development costs relating to income taxed under the DISC, FSC, and related provisions of the Internal Revenue Code. The unsettling effect of the Ninth Circuit's opinion on the tax system as a whole is a material concern to the Institute and its members. It is not unusual for large multinational companies such as Boeing to have many

years under examination by the Internal Revenue Service. The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the IRS. As individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets. The issue presented here involves the validity of a Treasury Regulation that improperly allocates research and development expenses to income under both the DISC and FSC provisions.

1. This case presents an ongoing question of significant importance on which the courts of appeals are in sharp conflict. The issue was previously decided in favor of the taxpayer in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994). Here, the Ninth Circuit found for the government, frankly admitting that it "decline[d] to follow the reasoning of *St. Jude Medical*."

The Ninth Circuit's opinion strips away the relative certainty taxpayers and the government had under *St. Jude Medical*—imposing significant administrative barriers to the resolution of this issue by taxpayers and the government. In the absence of a resolution, protracted litigation may be the only solution for large taxpayers that may have many years still open under the applicable statute of limitations.

Amicus TEI submits that this Court should resolve the conflict to preserve the uniform application of the tax law and to avoid disparate treatment of similarly situated taxpayers based solely upon their geographical location.

2. The resolution of the question presented in this case affects many companies and tax years, past, present, and future.

The IRS has reported that during 1992-1996 (the years for which the most recent data are available), the total income, cost of goods sold, foreign trade deductions, and net exempt income for FSCs all doubled, indicating an overall increase in the size of the average FSC. During the same period, there was a 42-percent increase in the number of FSC returns filed, and assets in these corporations rose almost 50 percent. Cynthia Belmonte, *Foreign Sales Corporations, 1996*, 19 STAT. OF INCOME BULL. No. 4, 87, 94 (Spring 2000). Estimates for the FSC replacement regime also demonstrate the importance of this issue: nearly $4.5 billion over a 10-year period. Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4986, FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, JCX-98-00 (Sept. 15, 2000). But perhaps the best way to confirm the national importance of the DISC and FSC provisions is to recognize that over three decades—whenever the regimes were threatened—Congress has always acted swiftly and consistently to enact replacement legislation.

In view of the substantial national importance of the DISC and FSC regimes, review by this Court is warranted.

3. The substantive tax issue in this case involves the allocation of Boeing's R&D expenses to the income generated by its export sales of commercial aircraft under the DISC and FSC provisions of the Code. The Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." The court's conclusion is wrong as a matter of law.

The DISC provisions permit corporations to defer part of their income tax on sales, licenses, or leases of export property that is manufactured or produced in the United States and sold or leased through a DISC for use outside the country. Boeing

used the combined taxable income (CTI) method for calculating its intercompany revenues. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis, but the taxpayer may annually elect to group the transactions according to product lines. The taxpayer's choice of groupings is controlling under the regulation. Before calculating its CTI, the taxpayer must allocate its costs—including R&D costs—between foreign and domestic sales. These costs are defined in Treas. Reg. § 1.994-1(c)(6)(iii) as "the expenses, losses, and other deductions *definitely related, and therefore allocated and apportioned, thereto,*" and a ratable part of any other expenses that are not definitely related to a class of gross income. The regulation references Treas. Reg. § 1.861-8, which allocates R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget.

Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred under Treas. Reg. § 1.994-1(c)(7). The IRS disagreed, maintaining that the allocation should be grouped according to SIC Code 37 for "Transportation Equipment," regardless of the relationship of the R&D expenses to the product being sold. Thus, the IRS's method reduced Boeing's CTI for a current program within a given year by the R&D expenses incurred for a different program that same year. The reallocation resulted in a tax deficiency of more than $400 million.

In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical*, which held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation. Finding the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case," the district court found that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the

computation of CTI that were "fatal" to the validity of the regulation. On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. The appellate court's reasoning is at odds with the DISC's statutory scheme and cannot be sustained.

The DISC statute clearly requires that there be a factual connection between income and expense. The legislative history confirms that expenses unrelated to property being exported are not allocated to export sales of the property. As the Ninth Circuit noted, a taxpayer is permitted to choose the pricing method that maximizes its DISC's profits. In spite of the regulation's clear language that a taxpayer's groupings "shall be controlling," the court found that Boeing *was required* under the regulations to use a broad two-digit SIC classification for allocating R&D expenses. As the Eighth Circuit determined in *St. Jude Medical*, however, "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted).

The DISC intercompany pricing rules are consistent with congressional intent because they permit taxpayers to choose their product groupings. Under the section 994 regulations, expenses directly related to a particular product group are not allocated to the sales from a different product group. Consistent with congressional intent, a DISC can therefore maximize the amount of its deferred tax on export income because its deductions are limited to directly related expenses and an allocated portion of unrelated expenses (such as overhead). This clearly accords with the statute.

The Ninth Circuit's decision forces taxpayers to allocate expenses that are directly related to a particular product—such as the Boeing 767—to income from unrelated products—such as the Boeing 747 which was designed years

before—because both the 747 and the 767 are in the same broad two-digit SIC Code. Even using a narrower three-digit SIC Code results in grouping such dissimilar products as floor wax and perfume or canned tuna and freeze-dried coffee. Such a ridiculous result cannot stand.

4. The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the IRS. As Justice Brandeis has noted, "it is more important that the applicable rule of law be settled than that it be settled right." *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). This case presents the opportunity for the Court to do both: to settle the issue and to get it right.

Boeing's Petition for a Writ of Certiorari should be granted.

ARGUMENT

I.

Over the past 30 years, Congress has enacted legislation that seeks to address the inequities that arise when U.S.-based companies compete in foreign markets because of the fundamental differences between the U.S. system of taxation and those of many other countries. The legislation provides a more level playing field for these companies. Two such regimes are under review in this case. In 1971, deficits in the United States' balance of trade led to the enactment of the domestic international sales corporation (DISC) provisions of the Internal Revenue Code. *See* Revenue Act of 1971, Pub. L. No. 92-178, 92nd Cong., 1st Sess. § 501; *L&F Int'l Sales Corp. v. United States*, 912 F.2d 377, 377 (9th Cir. 1990).[2] Following a

[2] A corporation qualifying as a DISC is not subject to current taxation. The DISC's parent corporation is taxed on a specified portion of the DISC income as a "deemed" distribution; the remaining income is tax-deferred until distributed to the parent or the corporation ceases to qualify as a DISC. The income is apportioned between the two entities according to one of three pricing methods. I.R.C. §§ 991-997. The pricing method used by Boeing here is the combined taxable income (CTI) method.

challenge under the General Agreement on Tariffs and Trade, Congress replaced the regime in 1984 with the foreign sales corporation (FSC) provisions. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess., § 801(a).[3] Although there are technical differences between the two regimes, the FSC provisions retain many features in common with the predecessor DISC statute. For more than three decades, these provisions have served their purpose.

This case involves the proper allocation of research and development expenses to income under both the DISC and FSC provisions,[4] an issue of significant importance on which the courts of appeals are in sharp conflict. As the district court recognized, this was not an issue of first impression. App. at 18a.[5] The issue was previously decided in favor of the taxpayer in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994). Here, the Ninth Circuit made no attempt to distinguish that case, but frankly admitted that it "decline[d] to follow the reasoning of *St. Jude Medical*." App. at 10a.

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[3] A FSC is generally not subject to taxation on its "exempt foreign trade income," which is treated as foreign source income not effectively connected with the conduct of a U.S. trade or business. Again, the income is apportioned between the FSC and its parent according to one of three alternative pricing methods. I.R.C.§§ 921-927.

[4] Parts of the DISC provisions technically remain in effect after the enactment of the FSC provisions. I.R.C. § 995. In 2000, because of a trade dispute over the validity of the FSC regime, Congress repealed the FSC provisions and enacted the extraterritorial income (ETI) provisions. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000), *codified at* I.R.C. §§ 114, 941-943. All three regimes implicate the same questions concerning the grouping of transactions and the allocation of research and development expenses. *See, e.g.*, I.R.C. § 943(b)(1)(B) (grouping of transactions for ETI purposes). Thus, the issue presented in this case has ongoing significance.

[5] References to "App." are to the appendix filed with Boeing's Petition for a Writ of Certiorari to the U.S. Court of Appeals for the Ninth Circuit, No. 01-1209 (Feb. 15, 2002).

As an organization dedicated to minimizing the costs and burdens of tax administration, *amicus* TEI is deeply concerned about the disruptive effect of the conflicting opinions. The companies that employ TEI's members have almost without exception been assigned to the Large and Mid-Size Business (LMSB) Division of the Internal Revenue Service (IRS). The largest 1,600 taxpayers within LMSB are subject to continual audits as part of the IRS's Coordinated Industry Cases (CIC) program. It is not unusual for these taxpayers to have many years still open for audit under the statute of limitations. The Ninth Circuit's opinion deprives taxpayers of the certainty promised by the decision in *St. Jude Medical* and casts doubt on the proper method for allocating research and development expenses. This uncertainty erects significant administrative barriers to the resolution of this issue by taxpayers and the government. Protracted litigation seems inevitable. In short, the Ninth Circuit's opinion has frustrated the orderly and principled administration of the tax laws.

Amicus TEI submits that this Court should resolve the conflict to preserve the uniform application of the tax law and to avoid disparate treatment of similarly situated taxpayers based solely upon their geographical location. "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system." *First Charter Fin. Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982). *Accord Nickell v Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987). Thus, the split in the circuits warrants review by this Court.

II.

This case has significant ramifications for companies other than Boeing. The resolution of the question presented in this case affects the taxes owed by thousands of other businesses that are also subject to these provisions. A review of the cases involving the regimes over the past 25 years illustrates some of the significant U.S. companies using FSCs and

DISCs. *See, e.g., Dresser Indus., Inc. v. United States*, 238 F.3d 603 (5th Cir. 2001) (DISC and FSC provisions); *General Electric Co. v. Commissioner*, 245 F.3d 149 (2d Cir. 2001) (DISC); *Intel Corp. v. Commissioner*, 76 F.3d 976 (9th Cir. 1996) (FSC and DISC); *St. Jude Medical*, 34 F.3d at 1304 (DISC); *Microsoft Corp. v. Commissioner*, 115 T.C. 228 (2000), *appeal pending*, No. 01-71584 (9th Cir.) (FSC); *Union Carbide Corp. v. Commissioner*, 110 T.C. 375 (1998) (FSC); *General Dynamics Corp. v. Commissioner*, 108 T.C. 107 (1997) (DISC and FSC); *Caterpillar Tractor Co. v. United States*, 589 F.2d 1040 (Ct.Cl. 1978) (DISC); *Oracle (Barbados) Foreign Sales Corp. v. Commissioner*, Tax Ct. Dkt. Nos. 13298-98 through 13301-98 (FSC).

In addition, under transition rules provided by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, taxpayers will have to determine their tax liability under these rules for many years to come. Further, although complete guidance has yet to be issued, it is inevitable that the grouping rules will be used in the implementation of the new ETI regime, highlighting the need for certainty in calculating tax liabilities. Thus, this case affects many companies and tax years, both past and present.

IRS statistical reports also demonstrate the importance of the provisions to business taxpayers. During the four-year period from 1992-1996 (the most recent years for which data are available), the IRS reported that the total income, cost of goods sold, foreign trade deductions, and net exempt income for FSCs all doubled, indicating an overall increase in the size of the average FSC. Cynthia Belmonte, *Foreign Sales Corporations, 1996*, 19 STAT. OF INCOME BULL. No. 4, 87 (Spring 2000) (hereinafter cited as "SOI"). During the same period, there was a 42-percent increase in the number of FSC returns filed, and assets in these corporations rose 48 percent to more than $26 billion. Total gross receipts of the FSCs and their related suppliers reached $285.9 billion in 1996, up from $152.3 billion four years earlier. A total of $12.4 billion

in deductions was allocated to the $20.9 billion of FSC exempt income in 1996. *Id.* at 87, 94.[6] Indeed, the amount of money at issue in this one case alone ($419 million through 1987) demonstrates the importance of this case for corporate taxpayers. App. at 1a.

The point is underscored by the estimates prepared by the staff of the Joint Committee on Taxation in 2000. The Joint Committee staff estimated that the revenue effects of the ETI provisions were nearly $4.5 billion over a 10-year period. Staff of the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4986, FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, JCX-98-00 (Sept. 15, 2000).[7]

But perhaps the best way to confirm the national importance of the DISC and FSC provisions is to consider the actions of Congress over three decades:

- Congress enacted the DISC provisions in 1971 to reduce the U.S. balance-of-payments deficits. H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 9, 58 (1971), *reprinted in* 1972-1 C.B. 498, 502, 529.
- When the DISC provisions were challenged under the General Agreement on Tariffs and Trade in the late 1970s, Congress enacted the FSC provisions as a replacement regime. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess., § 801(a).
- When those provisions were challenged 14 years later in the dispute resolution process of the World Trade Organization, Congress once again passed replace-

[6] Transportation equipment—the category in which Boeing's receipts fall—accounted for $51.9 billion of gross receipts. SOI at 87.

[7] The United States recently estimated that the effect of the FCS/ETI benefits in respect of the European Union's challenge to those regimes in the WTO is $4.15 billion in 2000 and $3.91 billion in 2001. *See Extraterritorial Income: U.S. Says Up to $1.11 Billion in Sanctions May Be Justified for FCS/ETI Retaliation*, BNA DAILY TAX REP., No. 40, at G-6 (Feb. 28, 2002). The EU's share of total world production for 2000 was 26.8 percent. *Id.* at G-7.

ment legislation. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

Thus, Congress has consistently acted to ensure the competitiveness of U.S. companies. In view of the substantial national importance of the DISC and FSC regimes, review by this Court is warranted to resolve the important question presented in this case.

III.

The substantive tax issue in this case involves the allocation of Boeing's R&D expenses to the income generated by its export sales of commercial aircraft under the DISC and FSC provisions of the Internal Revenue Code. The Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." App. at 2a. The court's conclusion is wrong as a matter of law.

Enacted to provide a more level playing field for U.S. companies competing in foreign markets, the DISC provisions permit corporations to defer part of their income tax on sales, licenses, or leases of "export property." That property must be manufactured or produced in the United States and sold or leased through a DISC for use outside the United States. In addition, not more than 50 percent of the property's fair market value may be attributed to products imported into the United States. I.R.C. § 993(c)(1). Intercompany pricing rules permit the taxpayer to elect one of three methods to determine the amount of revenue allocated to the DISC and its parent.[8] I.R.C. § 994(a).

[8] Many aspects of the statutory schemes are common to both the FSC and DISC provisions, for example, in the definition of "export property" and permissible pricing methods. For this reason, this brief follows the lead of the Ninth Circuit (App. at 6a n.3) and Boeing (Pet. at 3 n.2) in discussing only the DISC provisions of the Code. The FSC provisions differ from the DISC provisions in ways not pertinent to this case. App. at 6a n.3.

Boeing used the combined taxable income (CTI) method for calculating its intercompany revenues under section 994(a)(2) of the Code. App. at 3a, 7a. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis. The taxpayer may elect, however, to determine the transfer price "on the basis of groups consisting of products or product lines." The taxpayer's choice of groupings "shall be controlling" and "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such groupings." Treas. Reg. § 1.994-1(c)(6)(iv). Costs (other than the cost of goods sold) [9]—

> which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions *definitely related, and therefore allocated and apportioned, thereto,* and (b) a ratable part of any other expenses, losses or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in section 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added). Several years later, the government issued a special allocation rule for R&D expenses. Treas. Reg. § 1.861-8(e)(3)[10] provides that R&D expenditures that a taxpayer deducts under section 174 of the Code shall ordinarily be considered deductions related to all income reasonably connected with product categories determined by reference to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget.[11]

[9] Treas. Reg. § 1.994-1(c)(6)(ii) provides that the cost of goods sold is calculated under Treas. Reg. § 61-3.

[10] App. at 43a. This regulation was later repromulgated as Treas. Reg. § 1.861-17.

[11] This requirement was amended in 1995 to encompass three-digit SIC Codes. Treas. Reg. § 1.861-17(a)(2(ii).

Under Treas. Reg. § 1.994-1(c)(7), Boeing grouped its export sales by program and apportioned costs, including R&D costs, to the particular airplane program for which those costs were incurred. All such specific product R&D costs were allocated to a specific program in the year in which they were incurred.[12] App. at 3a. R&D costs relating to basic research were apportioned to all airplane programs.[13] *Id.* Upon audit, the IRS—relying on Treas. Reg. § 1.861-8(e)(3)—reallocated R&D costs to all of Boeing Company's income from current commercial airplane sales in a single category under SIC Code 37 ("Transportation Equipment"), regardless of the relationship of the R&D expenses to the product being sold. App. at 18a. The IRS's method reduced Boeing's CTI for a current program within a given year by the R&D expenses incurred for a different program that same year. App. at 24a. The reallocation resulted in a tax deficiency of more than $400 million. App. at 15a.

The substantive issue in this case is the validity of Treas. Reg. § 1.861-8(e)(3) as used to calculate Boeing's CTI. In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical,* which invalidated section 1.861-8(e)(3) as applied to the calculation of CTI. The district court found the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case." App. at 18a-19a. The court agreed with the Eighth Circuit that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the allocation of R&D expenses—defects that were "fatal" to the validity of the regulation. App. at 21a-23a.

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[12] Boeing referred to these R&D costs as "Company Sponsored Product Development," which were costs incurred for a specific program after the product was approved for development. App. at 3a.

[13] Boeing referred to these R&D costs as "Blue Sky R&D," which were costs incurred for basic research relating to commercial airplanes that might be the precursor to a specific program. App. at 2a-3a.

On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. App. at 6a. Concluding that the statute does not confine the relevant costs to be allocated to those definitely related to sales of a particular product, the court found that there is thus no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7). App. at 11a-12a. The Ninth Circuit's reasoning that Treas. Reg. § 1.861-8(e)(3) controls the calculation of CTI, however, is at odds with the DISC's statutory scheme and, upon careful review, cannot be sustained.

The DISC statute clearly requires a factual connection between income and expense. *See* I.R.C. § 994(a)(2) (requiring determination of net income "attributable to" the export sale). The legislative history of the provision confirms that "[t]hese rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis." H.R. Rep. No. 92-533, at 74, *reprinted in* 1972-1 C.B. 498, 538 (emphasis added). CTI is determined by "deducting from the DISC's gross receipts cost of goods sold with respect to the property of both the DISC and the related person which are *directly related to the production or sale of the export property.*" *Id.* (emphasis added). Thus, expenses unrelated to property being exported are not allocated to export sales of the property.

As the Ninth Circuit acknowledged (at 7a), a taxpayer is permitted under Treas. Reg. § 1.994-1(c)(6)(iv) to choose the pricing method that maximizes its DISC's profits. In spite of the regulation's clear language that a taxpayer's groupings "shall be controlling," the court found that Boeing may not group its products along product lines but rather *was required* to use a broad two-digit SIC classification for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3). As the Eighth Circuit determined in *St. Jude Medical*, however,

"[m]andating use of SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted). Moreover, the deemed relationship (between an expenditure for R&D and all income reasonably connected with a broad product category) mandated by the regulation is "inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related thereto.*'" *Id.* Finally, the SIC categories requiring gross income derived from successful R&D to bear the costs of the unsuccessful R&D are inconsistent with Congress's stated intent to deduct from the DISC's gross receipts only those costs that are directly related to the production or sale of the export property. *Id.*

In contrast to the challenged section 861 regulations, the section 994 regulations on intercompany pricing rules are consistent with congressional intent because they permit taxpayers to choose their product groupings. *Id.* Under section 994, expenses directly related to a particular product group (as defined by the taxpayer) cannot be allocated to the sales from a different product group. Thus, a DISC can maximize the amount of its deferred tax because its deductions from the gross income for a particular product line are limited to the expenses that directly relate to that product (and an apportioned portion of expenses not directly related to any product, such as overhead).[14] This clearly accords with the statute.[15]

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[14] *See St. Jude Medical*, 34 F.3d at 1402-03 ("Although a taxpayer may choose to allocate R&D expenditures to SIC categories consistent with Congress's intent when it promulgated the DISC intercompany pricing rules, mandating that the taxpayer do so is inconsistent with congressional intent. Doing so may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules.").

[15] That Boeing's R&D expenditures may have exceeded its income in a given product category in any year is irrelevant. The section 861 regulations clearly contemplate situations in which the costs directly related to a particular product line will exceed the gross income generated by that product line in a particular year. Treas. Reg. § 1.861-8(d)(1) specifically states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [dealing with the 'factual relationship between the deduction and a class of gross income'] even though, for the taxable year, *no gross income in such class is received.*" (Emphasis added.) The specific regulation relied upon by the government for the allocation of R&D expenses also provides that "[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping." Treas. Reg. § 1.861-8(e)(3)(ii)(B). This is consistent with the current deductibility of R&D expenses and the result of the annual accounting for taxes.

The Ninth Circuit's decision forces taxpayers in that circuit to allocate expenses that are directly related to a particular product—such as the Boeing 767—to income from unrelated products—such as the Boeing 747 which was designed years before—because both the 747 and the 767 are in the same broad two-digit SIC Code. There are significant differences even among products that may seem superficially similar. Even allocations within the slightly narrower three-digit SIC Codes now set forth in Treas. Reg. § 1.861-17 can lead to absurd results. For example, R&D expenses directly related to main frame computers would be allocated to pencil sharpener receipts because both pencil sharpeners and computers are in the same three-digit SIC Code (357—Computer and Office Equipment). Examples of other product groupings include canned tuna fish and freeze-dried coffee (SIC Code 209), perfumes and floor wax (SIC Code 284), and batteries and extension cords (SIC Code 369). Such ridiculous results cannot stand. The mandatory use of SIC Codes is an unreasonable interpretation of the DISC statute.[16]

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[16] In other areas, the government has recognized that the allocation of expenses according to SIC Codes may not always make sense. For example, for purposes of the possessions tax credit, the regulations provide that

IV.

As Justice Brandeis has noted, "it is more important that the applicable rule of law be settled than that it be settled right." *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). This case presents the opportunity for the Court to settle the issue and to get it right.

Because tax considerations play an important role in business decisions, "there is a special interest in the orderly, certain, and consistent interpretation of the Internal Revenue Code." *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 416 (1983) (Stevens, J. dissenting). That interest is not served by the Ninth Circuit's opinion. Moreover, the need for certainty and consistency is particularly acute where the statutes are intended to provide relief for taxpayers.

The Ninth Circuit's decision will undoubtedly increase the number of disputes between taxpayers and the Internal Revenue Service. This is undesirable because "[t]he taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are." *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

Boeing's Petition for a Writ of Certiorari should be granted and the Ninth Circuit's opinion reversed.

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marketing and distribution expenses shall generally be allocated according to a three-digit SIC Code, but the taxpayer may establish that the expenses are directly related to a specific class of income defined by specific product or group of product. *See* Treas. Reg. § 1.936-6(b)(1)(ii).

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari.

Respectfully submitted,

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In The

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THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, AND BOEING SALES CORPORATION,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ of Certiorari To The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF BRUNSWICK CORPORATION, HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, AND REEBOK INTERNATIONAL LTD. IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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In The

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No. 01-1209

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, AND BOEING SALES CORPORATION,

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v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ of Certiorari To The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF BRUNSWICK CORPORATION, HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, AND REEBOK INTERNATIONAL LTD. IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

INTEREST OF THE *AMICI CURIAE*

Amici Curiae are five publicly held United States corporations representing a broad spectrum of industries,[1] including marine engines, recreational watercraft, imaging and printing systems, computing systems, information technology services, microprocessors, chipsets, sports and fitness products, semiconductor and microelectronics testing equipment, data storage devices, and athletic footwear and apparel products. Each company engages in significant research and development ("R&D") activities and is profoundly interested in the export laws of the United States and the tax incentives enacted by Congress.

[1] All parties to this proceeding have consented to the submission of this brief in letters of consent filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae*, made a monetary contribution to the preparation or submission of this brief.

Amici curiae are adversely affected by a decision of the United States Court of Appeals for the Ninth Circuit that interprets the application of a Treasury regulation in direct and irreconcilable conflict with a 1994 decision in the Eighth Circuit. This conflict alone warrants this Court's exercise of jurisdiction to ensure uniform treatment in the administration of our nation's federal tax laws. Inevitable and continued litigation over the Treasury regulation at issue is virtually certain, with the attendant consequence that taxpayers will be treated differently depending on the venue of adjudication. This type of conflict is corrosive to the confidence that all citizens must have in the administration of our federal tax system. This Court should grant the petition, rather than allow the conflict to continue among the courts of appeals to the detriment of the *amici curiae* and hundreds of other similarly situated taxpayers.

Brunswick Corporation ("Brunswick") is incorporated in the State of Delaware, with its principal executive offices located in Lake Forest, Illinois. Brunswick is a leading manufacturer and marketer of marine engines, recreational watercraft, fitness and exercise equipment, and bowling and billiards products. Brunswick produces many of its products at manufacturing plants in the United States, and sells those products in the domestic market and worldwide directly to original equipment manufacturers and through distributors and dealers. Brunswick's sales to customers in international markets exceeded $835 million in 2000. R&D activities are important to maintaining and expanding Brunswick's product lines. Brunswick's growth strategies include investing in leading-edge technologies and innovative products. In 2000, Brunswick's R&D investments relating to new products and the improvement of existing products exceeded $100 million.

Hewlett-Packard Company ("HP") is incorporated in the State of Delaware, with its principal executive offices located in Palo Alto, California. HP is a leading global provider of business and home products in its three major business segments: Imaging and Printing Systems, Computing

Systems, and Information Technology Services. HP is the world's largest imaging and printing systems provider for printer hardware, printing supplies and scanning devices. HP Computing Systems products include commercial and home personal computers ("PCs"), UNIX servers, PC servers, storage and software solutions. The Information Technology Services segment provides leading customer support, consulting, outsourcing and other services that allow customers to take advantage of emerging technologies and business models. The markets for HP's three principal business segments are characterized by short product life cycles and require the vigorous development of new and enhanced products and services. Hewlett-Packard Laboratories ("HP Labs"), together with the efforts within the three principal business segments, conduct R&D to provide a continuing flow of innovative, high-quality products and services and to enhance current product offerings. Expenditures for R&D in fiscal 2001, including HP Labs and the three principal business segments, were $2,700 million. HP's research, product development, and manufacturing are conducted in the United States and in numerous locations throughout the world. HP maintains operations in more than 120 countries worldwide and sells products and services into additional locations through various representatives and distributors.

Intel Corporation ("Intel") is incorporated in the State of Delaware, with its principal executive offices located in Santa Clara, California. Intel supplies the basic building blocks and ingredients of computer architecture and the internet economy. Intel is the world's largest semiconductor chip maker, and its products include microprocessors, which control the central processing of data in personal computers, servers, workstations, and other devices; chipsets, which perform essential logic functions surrounding the central processing units in computers based on Intel architecture processors; and embedded control chips for automobile engines and breaking systems, hard disk drives, cellular

phones, and laser printers. Intel's competitive position has developed in large measure because of its emphasis on R&D activities. In 2000, Intel's R&D expenditures totaled $3,897 million, and were devoted to the development of new products, as well as the enhancement of existing products. Intel's products are produced in the United States and in numerous locations abroad, and are sold for use in countries throughout the world.

KLA-Tencor Corporation ("KLA-Tencor") is incorporated in the State of Delaware, with its principal executive offices located in San Jose, California. KLA-Tencor was formed in April 1997 through the merger of KLA Instruments Corporation and Tencor Instruments, two long-time participants in the semiconductor equipment industry. KLA-Tencor is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. KLA-Tencor sells a broad spectrum of semiconductor equipment products designed to assist integrated circuit manufacturers manage yield throughout the wafer fabrication process from the research and development phase to final mass production yield analysis. The markets served by KLA-Tencor are characterized by rapid technological development and product innovation. Accordingly, KLA-Tencor devotes a significant portion of its human and financial resources to R&D programs, and is committed to significant engineering efforts toward product improvement and new product development. The company's global customer base includes virtually every major semiconductor manufacturer in the world, and its products are sold throughout the United States, Europe, Asia-Pacific, and Japan.

Reebok International Ltd. ("Reebok") is incorporated in the Commonwealth of Massachusetts, and its principal executive offices are located in Canton, Massachusetts. Reebok is a global company, engaged primarily in the design and marketing of sports and fitness products. Reebok is one of the world's leading companies engaged in the design,

marketing, and distribution of sports, fitness, and casual footwear, apparel and equipment under the Reebok, Rockport, and Greg Norman brands, and footwear under the Polo Ralph Lauren brand. Reebok engages in product R&D and design activities at its product development facilities. R&D activities are integral to the company's success. Reebok places strong emphasis on technology and incorporates various proprietary performance technologies in its products. Reebok sells its products throughout the United States and in approximately 170 countries and territories worldwide. Reebok footwear and apparel products are distributed in the United States primarily through athletic retailers, sporting goods stores, and department stores. Reebok's sales outside the United States are conducted through its international distribution network, consisting of related entities and independent distributors around world.

On a cumulative basis, the *amici curiae* produce thousands of products in a wide variety of industries. Those products are sold in markets throughout the world. Individually, each company conducts substantial R&D activities and is vitally interested in the tax incentives granted by Congress. The Ninth Circuit decision below jeopardizes those incentives and the *amici curiae* submit that it is essential for this Court to review and resolve the fundamental issue presented in this proceeding.

The *amici curiae* are located throughout the United States. In federal income tax cases, one or more of the *amici curiae* are subject to the appellate jurisdiction of the courts of appeals of the First, Seventh, Ninth, or Federal Circuits. *See* 26 U.S.C. § 7482(b)(1)(B), 28 U.S.C. § 1294(1), 28 U.S.C. § 1205(a)(3).[2] The potential adverse implications of the

[2] Taxpayers have the option in most cases to bring an action relating to a federal income tax issue in the United States Tax Court or the appropriate United States District Court. *See* 26 U.S.C. § 6213(a), 28 U.S.C. § 1346(a)(1). In certain cases, taxpayers also have the option to bring a refund suit in the United States Court of Federal Claims. *See* 28 U.S.C. § 1346(a)(1). Appellate jurisdiction for tax cases decided by the United

decision below are obvious for the *amici curiae* subject to the appellate jurisdiction of the Ninth Circuit (*i.e.*, HP, Intel, and KLA-Tencor).[3] The *amici curiae* subject to the appellate jurisdiction of other courts of appeals (*i.e.*, Brunswick and Reebok) are disadvantaged by the uncertain results from the present split in the Eighth and Ninth Circuits. Only this Court can eliminate that uncertainty and ensure a uniform rule for all taxpayers.

The *amici curiae* appear in this proceeding to enhance the Court's understanding of two important matters. First, the decision below and the conflict in the courts of appeals create unwarranted inequities and unfairness among similarly situated taxpayers. Second, the Ninth Circuit decision frustrates two policies of profound national interest: encouragement of innovative R&D activities, and stimulation of exports from the United States.

STATEMENT

This proceeding involves an issue of fundamental importance involving R&D activities and export tax incentives. Commencing in 1954, Congress provided tax incentives to encourage R&D activities by United States businesses. *See, e.g.*, Internal Revenue Code §§ 41, 174(a).[4] During the last sixty years, Congress has also enacted four separate tax regimes designed to stimulate and increase the export of products from the United States.[5] The taxable

States Court of Federal Claims lies with the United States Court of Appeals for the Federal Circuit. *See* 28 U.S.C. § 1205(a)(3).

[3] Although taxpayers subject to the appellate jurisdiction of the Ninth Circuit may be able to bring a tax refund suit in the United Sates Court of Federal Claims (*see* 28 U.S.C. § 1346(a)(1)), their Tax Court and district court options are curtailed, if not foreclosed, by the decision below.

[4] References to sections of the Internal Revenue Code (26 U.S.C.) are to the Internal Revenue Codes of 1954 and 1986, as amended and in effect for the years at issue, unless otherwise stated.

[5] In 1942, Congress provided export tax incentives to "Western Hemisphere Trade Corporations." *See* Internal Revenue Code of 1939 §

years at issue in the matter before the Court involve two of those regimes, namely the Domestic International Sales Corporation ("DISC") provisions, and the Foreign Sales Corporation ("FSC") provisions.[6]

The specific question presented in this proceeding concerns the application of a Treasury regulation[7] to the computation of export sales income under the DISC and FSC provisions of the Internal Revenue Code (26 U.S.C.). In 1994, the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of R&D expenses) was unreasonable and invalid when applied to the calculation of income under the DISC regime. *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394, 1396 (8th Cir. 1994). Seven years later, the court of appeals below reached the opposite conclusion on virtually identical facts.

Simply stated, the issue in this proceeding is whether, for purposes of calculating export benefits under the DISC regime, taxpayers must allocate R&D expenses to extremely

109; Internal Revenue Code of 1954 §§ 921-922 (prior to repeal); S. Rep. No. 1631, 77th Cong., 2d Sess. 32, 111 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954). In 1971, Congress granted export tax incentives for "Domestic International Sales Corporations." *See* Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497. The "Foreign Sales Corporation" regime was enacted in 1984. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494. Most recently, export incentives were enacted in the Extraterritorial Income Exclusion Act of 2000. *See* Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

[6] In the proceeding below, the parties agreed that for purposes of the issue in the present case there are no significant differences between the DISC and FSC regimes. *See* Pet. at 3, n.2; Pet. App. B. at 20a, n.2. References to "Pet." or "Pet. App." are to Petitioners' Petition For a Writ of Certiorari, and the Appendices thereto, in this proceeding (No. 01-1209). For convenience, the discussion herein is based only on the DISC provisions, unless the context requires otherwise.

[7] References to sections of the regulations are to the Department of Treasury regulations, as published in 26 Code of Federal Regulations, and as in effect during the years at issue, unless otherwise stated.

broad product categories (such as "transportation equipment"), or whether taxpayers have an undeniable right to allocate R&D expenses to more narrow product groups to which the expenses "directly relate." The Ninth Circuit below held that taxpayers are required to allocate R&D expenses to broad product categories, even if those expenses *do not* directly relate to the export sales. *See* Pet. App. A, at 13a. Conversely, the Eighth Circuit held the Treasury regulations provide taxpayers a right to choose recognized product or product line groups and to allocate R&D expenses to those specific product groups. *See St. Jude Medical,* 34 F.3d at 1396.

Under the DISC tax incentive regime, Congress allowed taxpayers to select one of three pricing methods to compute the maximum tax benefit from export activities. *See* I.R.C. § 994(a). The particular pricing approach at issue in this proceeding is the "combined taxable income" method ("CTI"), which is a net income concept calculated by determining gross export sales receipts and subtracting costs (including R&D costs) from those receipts. *See* I.R.C. § 994(b)(2). The legislative history to the DISC regime provides that CTI is determined by deducting expenses "directly related" to the production or sale of export property, and a portion of the expenses not allocable to "any specific item of income." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The regulations follow this legislative intent and provide that costs treated as relating to export gross receipts are those that are "definitely related" to the export sales, and a ratable part of other expenses not definitely related to a class of gross income, "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii).

For purposes of computing export income qualifying for the DISC incentive, the computations can be made on a "transaction-by-transaction basis." Treas. Reg. § 1.994-1(c)(7)(i). As an alternative to transaction-by-transaction determinations, Congress intended to provide, and the

regulations grant, taxpayers the right to "group" transactions on the "basis of groups consisting of products or product lines." *Id.; see* H.R. Rep. No. 533, *supra*, at 74. The regulations further provide that the taxpayer's grouping choice "will be accepted" if it conforms with either (i) "recognized industry or trade usage," or (ii) "the two-digit major groups" of the Standard Industrial Classification ("SIC") manual, issued by the Office of Management and Budget. Treas. Reg § 1.994-1(c)(7)(ii). The regulations also provide that the taxpayer's choice "shall be controlling," and costs "shall be allocated and apportioned to the items or classes of gross income***resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

These regulatory provisions establish basic principles in computing income subject to the DISC export incentives. First, a taxpayer is granted the right to "group transactions" on the basis of specific "products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). Second, the taxpayer's grouping choice "will be accepted" if it conforms to a recognized industry or trade usage standard. Treas. Reg. § 1.994-1(c)(7)(ii). Assuming the choice conforms to such standard, the taxpayer's grouping "shall be controlling" and costs shall be allocated and apportioned to those groups. Treas. Reg. § 1.994-1(c)(6)(iv). Finally, costs "directly related" to those groups shall be allocated thereto, and costs directly related to non-export classes of income shall not be allocated to export sales. *See* Treas. Reg. § 1.994-1(c)(6)(iii).

The Treasury regulation relating to the allocation or apportionment of R&D expenses (Treas. Reg. § 1.861-8(e)(3)) directly conflicts with the DISC legislative history and the DISC regulations. Under Treas. Reg. § 1.861-8 (e)(3), R&D expenses are allocated or apportioned to all products falling within broad two-digit categories, as enumerated in the SIC manual. Expenses are allocated to the broad SIC code categories regardless of whether the costs have any direct relationship to those categories. To the extent this regulation allocates R&D expenses to broad

product categories that have *no* direct or definite factual relationship to the specific products or product lines chosen by the taxpayer, the provision is directly contrary to the DISC statute, legislative history, and regulations. Consequently, as applied to such DISC determinations, Treas. Reg. § 1.861–8(e)(3) is unreasonable and invalid. *See St. Jude Medical*, 34 F.3d at 1396.

Petitioners followed the applicable regulatory rules and chose to "group transactions" on the basis of specific product lines under recognized industry or trade usage, and not on the basis of the broad two-digit SIC code category relating to "transportation equipment."[8] Despite the clear regulatory scheme, the Ninth Circuit found Petitioners were required to use the broad two-digit SIC code classification category, rather than the specific product lines selected by Petitioners pursuant to the right envisioned by Congress and granted under Treas. Reg. § 1.994-1(c)(7). Petitioners had an undeniable right to use the more specific product categories instead of the broad classifications imposed by the invalid Treasury regulation. *See St. Jude Medical,* 34 F.3d at 1396.

SUMMARY OF ARGUMENT

This case presents an irreconcilable conflict in the circuits which is unusually harsh because it creates unfairness among similarly situated taxpayers across the United States. Taxpayers located in one part of the country (subject to the appellate jurisdiction of the Eighth Circuit) receive the benefits intended by Congress in fostering R&D activities and providing export incentives. Taxpayers located in a different part of the country (subject to the appellate jurisdiction of the Ninth Circuit) are denied the full measure of those benefits. Taxpayers located in still other parts of the country must endure uncertainty and confront the possibility of lengthy and expensive audits and litigation with the

[8] There is no disagreement that each of the product lines selected by Petitioners "constituted a separate product or product line under industry practice and trade usage." *See* Pet. App. A, at 2a; Pet. App. B, at 16a.

Internal Revenue Service ("IRS"). It is patently unfair for one set of taxpayers to be deprived of the full benefit of the export incentives provided by Congress, while other taxpayers receive their entitlement to those benefits.

The Ninth Circuit decision frustrates national policies encouraging R&D activities and granting export incentives. In a perverse way, the decision below imposes a financial penalty on companies conducting valuable R&D activities, and denies the benefits of the export tax incentives promised by Congress, thereby directly impeding Congress' goal of increasing exports.

The decision by the court of appeals leads to negative practical consequences. The Ninth Circuit decision increases the costs of conducting innovative activity, undermines financial incentives to operate manufacturing plants in the United States and could lead to the loss of employment, increases our trade deficit dilemma, and places United States companies at a global competitive disadvantage *vis-à-vis* companies located abroad. Prompt review by this Court is appropriate and necessary.

REASONS FOR GRANTING THE WRIT

I. THE DIRECT CONFLICT IN THE CIRCUITS CREATES INHERENT UNFAIRNESS AND INEQUITIES.

This case presents a direct conflict in the courts of appeals on a key question of federal law. In *St. Jude Medical*, the Court of Appeals for the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) "is invalid as applied to DISC CTI computations." *St. Jude Medical,* 34 F.3d at 1396. In the decision below, the Court of Appeals for the Ninth Circuit found the same provision to be valid as "a reasonable interpretation of the applicable statutes and regulations." Pet. App. A, at 13a. The two cases are indistinguishable in all material respects and the conflict between the circuits is clear, direct, and indisputable.

The conflict involves a significant matter and raises a fundamental question relating to the encouragement of R&D activities and United States international trade policy. The relevant provisions of the Internal Revenue Code (26 U.S.C.) relating to R&D activities were enacted to encourage companies to engage in innovative research efforts. *See* Ways and Means Committee Rept., H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28, 57 (1954). The DISC provisions were enacted to provide incentives for United States companies to increase their exports to other countries. *See* H.R. Rep. No. 533, *supra*, at 58. The conflict in the circuits directly implicates these vital national policies designed to ensure United States companies are able to compete on a fair and balanced level in the world trade arena. The courts of appeals are irreconcilably divided on this important question and the issue should be resolved by this Court.

Although the direct conflict in the circuits, standing alone, warrants consideration by this Court, the need for immediate review is particularly acute here because the conflict creates inherent unfairness and inequities. It is inequitable to allow a company in one geographic location to receive the full benefits of its R&D expenditures, while simultaneously penalizing companies incurring those same costs located in other geographic locations. In the Ninth Circuit, R&D expenditures not directly related to export sales inappropriately reduce the value of export tax incentives granted by Congress. In the Eighth Circuit, the identical R&D expenditures do not reduce those export incentives. The decision below creates an inequitable penalty for companies engaged in R&D activities *unrelated* to the sale of export property.

The Ninth Circuit decision significantly dilutes the value of historically important export incentives. Those incentives were provided by Congress without regard to the geographic location of the taxpayer in the United States. It is unfair to deprive taxpayers located in one part of the country the

export benefits promised by Congress and allow taxpayers located in a different part of the country to receive their entitlement to those benefits. Under the rule adopted by the court below, competitors in different locations bear significantly different tax liabilities with respect to their export activities. The conflict in the courts of appeals results in this unfairness and necessitates immediate review by this Court.

Finally, the conflict in this proceeding presents an issue that will continue to arise in a significant number of cases across the country. In 1995, and again in 1999, the IRS nonacquiesced[9] in the Eighth Circuit decision in *St. Jude Medical*. *See* Actions on Decisions, 1995-2 C.B. 2 (1995), 1999-2 C.B. xvi-xvii (1999); IRS AOD 1995-001 (February 13, 1995); IRS AOD 1999-005 (August 30, 1999). In the second action on decision, the IRS stated that it "will continue to litigate our position in the other circuits." IRS AOD 1999-005 (August 30, 1999). Following *St. Jude Medical*, and the nonacquiescence in that decision, the IRS challenged Petitioners' computation of CTI and attempted to convince another court of appeals to reach a different conclusion. The IRS was successful in the court below and the IRS is likely to rely on the Ninth Circuit decision to challenge taxpayers across the nation.[10]

This threat of litigation creates immediate uncertainty for companies engaged in critically important R&D efforts and export activities. Further, for companies considering the

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[9] In reference to an opinion by a circuit court of appeals, the term "nonacquiescence" signifies that although the IRS recognizes the precedential impact of the opinion on cases arising within the venue of the deciding circuit, the IRS will not follow the holding on a nationwide basis. *See* Actions on Decision, 1999-2 C.B. xvi (1999).

[10] In the 1995 action on decision in *St. Jude Medical*, the IRS stated that the "issue should continue to be litigated and/or defended since it also arises in the context of *** Foreign Sales Corporations ***." IRS AOD 1995-001 (February 13, 1995).

advantages of commencing or expanding export activities in the United States, the decision below creates a serious deterrent to such efforts. This case presents an important reoccurring issue, and there is nothing to be gained by postponing this Court's consideration of the overarching question.

II. THE DECISION BELOW FRUSTRATES TWO VITAL NATIONAL POLICIES: ENCOURAGEMENT OF R&D EFFORTS, AND STIMULATION OF EXPORT ACTIVITIES.

A. The Ninth Circuit Decision Increases the Costs of Conducting Critical R&D Activities.

R&D activities represent the innovative forces necessary for the development of new products and technologies and for maintaining and enhancing existing products. National policies have existed for at least forty-eight years providing tax benefits to encourage taxpayers to carry on R&D activities. In 1954, Congress enacted a special provision in the Internal Revenue Code granting taxpayers an election to deduct currently R&D expenditures. *See* I.R.C. § 174(a). This election was granted to "encourage taxpayers to carry on" R&D activities. *See* H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954); *Snow v. Commissioner,* 416 U.S. 500, 504 (1974).

In 1981, Congress expressed concern over our nation's decline in R&D activities and concluded that "spending for these purposes had not been adequate." *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, H.R. 4242, 97th Cong., 1st Sess. 119 (1981). To reverse the decline in R&D spending, Congress decided that a tax credit for incremental R&D expenditures was needed "to overcome the reluctance" to bear costs needed to "initiate or expand research programs." *Id.* at 120. In response, Congress enacted a new provision of the Internal Revenue Code (currently, I.R.C. § 41) allowing

an income tax credit for certain qualified research expenditures incurred by a taxpayer in carrying on a trade or business.[11] The purpose of the credit was to "encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 904 (1984).[12] This history of legislative action reflects a strong national policy for almost fifty years encouraging United States taxpayers to engage in R&D activities designed to enhance existing products and create new products and technologies.

The R&D incentives in the Internal Revenue Code have encouraged the development of many existing and new innovative products and industries. Each of the a*mici curiae* engages in significant R&D activities in its respective markets. Those activities are vitally important to the world class positions the *amici curiae* have attained in their industries. The court of appeals decision below frustrates this key national policy because it increases the financial cost for companies engaging in R&D activities that could yield unsuccessful products, products sold only in the domestic market, or products otherwise *unrelated* to export income.

Under the Ninth Circuit decision, every dollar of R&D expenditures *unrelated* to export receipts creates a financial disadvantage for companies to the extent allocated or

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[11] The R&D credit was originally enacted as I.R.C. § 44F, but was subsequently renumbered as I.R.C. § 30 (*see* Tax Reform Act of 1984, Pub. L. 98-369), and most recently as I.R.C. § 41 (*see* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085).

[12] An expiration date for the R&D credit was deemed desirable to enable Congress to evaluate the experience with the credit, and to "determine whether it should be extended***." S. Prt. No. 169, *supra,* at 904. The credit has been extended numerous times since 1981. *See, e.g.,* The Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686. In 1999, Congress extended the R&D credit through June 30, 2004 in the Tax Relief Extension Act of 1999, Pub. L. No. 105-277, § 1001.

apportioned to products sold for export under the DISC provisions. Assuming a set of products in the same broad SIC code category, the rule adopted by the Ninth Circuit means that R&D expenses directly related to unsuccessful products not brought to market must be allocated or apportioned to current export income under the DISC provisions. Further, R&D expenditures directly related to products sold only in the domestic market must also be allocated or apportioned to export receipts. Under the reasoning of the court below, every dollar of these R&D expenses reduces the export tax incentives enacted by Congress. This rule applies even though the R&D expenses *are not* factually related to the taxpayer's export products or export income. In essence, the Ninth Circuit decision imposes a financial penalty for engaging in these R&D activities. Such an aberrational result should not stand.

The Ninth Circuit decision imposes a significant financial cost on companies engaging in critical R&D activities, and runs directly counter to historically important policies reflected in legislation enacted by Congress for almost fifty years. The decision below undermines one of our country's most fundamental policies—the encouragement of broad-based R&D activities to create innovative products and to enhance existing products and technologies. The detrimental impact of the decision below on this key national policy warrants immediate review by this Court.

B. The Ninth Circuit Decision Significantly Dilutes an Important Export Incentive.

Congress has been vitally interested in promoting exports through special incentives in the Internal Revenue Code for more than sixty years. [13] One of the earliest export tax incentive regimes was enacted in 1942 for Western Hemisphere trade corporations ("WHTCs"). The WHTC regime was enacted to "alleviate ***competitive inequality."

[13] *See* note 5, *supra*.

S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942). Until 1980, WHTCs enjoyed a fourteen percentage point reduction in the normal corporate tax rate related to exports and business activities conducted in the Western Hemisphere. I.R.C. §§ 921-922 (1954). Commencing in 1971, Congress granted special tax benefits to DISCs to encourage the export of goods manufactured in the United States, and to equalize the taxation of United States companies with the European territorial system. *See* Pub. L. No. 92-178 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). The DISC regime gave rise to complaints from other countries on the basis that it was an export subsidy in violation of the General Agreement on Tariffs and Trade. In 1984, Congress responded to these complaints by replacing the DISC rules with the FSC provisions. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494.

Enactment of the FSC provisions did not deter attacks by other countries on our international trade policies, and in 2000 the World Trade Organization ("WTO") found that the FSC provisions were a prohibited export subsidy. In November 2000, Congress responded by repealing the FSC provisions and enacting a new provision referred to as the extraterritorial income exclusion ("ETI"). *See* Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000). The European Union filed a new complaint against the ETI provisions and in August 2001 a WTO panel held the new provisions also constituted a prohibited export subsidy.[14] Subsequently, in January 2002, an appellate body of the WTO modified and affirmed the panel's findings.[15] Congress is considering various alternatives for resolving the WTO dispute while continuing

[14] United States–Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

[15] *Id.*, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002.

to provide export incentives so that United States businesses can compete on a fair and level playing field with companies based abroad.[16]

This long history of disputes relating to United States exports, international trade policies, and successive enactments by Congress of export incentives reflects vital national policies. It is in our national interest to encourage the export of products from the United States. Export activities create domestic jobs, facilitate capital investment, encourage construction of plants in our country, improve our balance of payments position, favorably impact interest rates, and support the value of the United States dollar in markets throughout world. Congress has recognized the importance of these national objectives and has sought to provide export incentives to United States businesses continually over a sixty-year period.

Congress specifically enacted the DISC statute to provide tax incentives to increase exports of products produced in the United States and in response to incentives provided by other major trading nations fostering foreign trade and encouraging exports by their domestic producers. *See* S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971); *Caterpillar Tractor Co. v. U.S.*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The FSC and ETI regimes continue this congressional policy of providing incentives to stimulate export activities. In enacting the DISC provisions, Congress provided taxpayers incentives to "maximize DISC profit." *See St. Jude Medical*, 34 F.3d at 1397. In computing the maximum DISC benefit, Congress intended that "directly related" expenses should be allocated to export income. H.R. Rep. No. 533, *supra,* at 74.

[16] *See* Hearings Before the House Committee on Ways and Means on the WTO's Extraterritorial Income Decision (February 27, 2002). It is anticipated that the regulations interpreting the ETI provisions, as well as any subsequent legislation, will also present the issue in this proceeding. Consequently, this issue has continuing importance and relevance from the original DISC legislation, through the FSC and ETI provisions, and the anticipated future legislation in this area.

Congress further intended to grant taxpayers the right to choose groupings by specific product or product lines, and to allocate expenses directly related to those products or product lines. *See* H.R. Rep. No. 533, *supra*, at 74. The Treasury regulations reflect these basic principles, (Treas. Reg. §§ 1.994-1(c)(6)(iii), 1.994-1(c)(7)(i)), and this right to group transactions has been codified in subsequent export legislation.[17]

Contrary to this legislative intent and regulatory scheme, the Ninth Circuit decision requires taxpayers to allocate R&D expenses to broad SIC code categories (rather than the specific product groupings selected pursuant to the right granted by Congress). The approach of the court below requires the allocation or apportionment of entirely *unrelated* R&D expenses to export receipts, thereby significantly diluting the incentives enacted by Congress. The court of appeals decision below is contrary to the congressional intent behind the DISC provisions and frustrates key national policies designed to encourage and increase exports.

The court of appeals decision also leads to negative practical consequences. The DISC regime was enacted to encourage production of export products in the United States, rather than supplying products to customers from overseas locations. *See* H.R. Rep. No. 533, *supra,* at 58. The Ninth Circuit decision reduces the financial advantages of producing products in the United States. Movement of production capacity overseas leads to plant closures and the loss of jobs in United States. Reduction in exports exacerbates our foreign trade deficit, and negatively impacts interest rates in our country and the value of the United States dollar abroad. In an economic environment where our

[17] I.R.C. § 927(d)(2)(B) (1984) (FSC regime), I.R.C. § 943(b)(1)(B) (2000) (ETI regime); *see Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules,* Joint Committee on Taxation (JCX-10-02) 10, February 25, 2002.

nation is struggling to emerge from its first recession in a decade, these are critical practical considerations that emerge from the decision below and justify immediate review by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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No. 01-1209

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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QUESTION PRESENTED

Whether Treas. Reg. § 1.861-8(e)(3), which prescribes a general rule for the allocation of research and development expenses in the computation of taxable income, may be applied in the context of export sales entitled to special tax treatment under the Internal Revenue Code.

RULES 24.1 AND 29.6 STATEMENT

The parties to this proceeding are The Boeing Company and Consolidated Subsidiaries and Boeing Sales Corporation. Boeing Sales Corporation is a wholly owned subsidiary of The Boeing Company. No publicly held company owns 10 percent or more of The Boeing Company's stock.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 258 F.3d 958. The opinion of the district court (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001, and a timely petition for rehearing was denied on November 19, 2001 (Pet. App. 25a). The petition for a writ of certiorari was filed on February 15, 2002, and was granted on May 28, 2002. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. ("IRC") § 994, 26 U.S.C. § 861, 26 C.F.R. ("Treas. Reg.") § 1.994-1, and 26 C.F.R. § 1.861-8 are reprinted at Pet. App. 26a-53a.

STATEMENT

This case concerns successive sets of tax provisions enacted by Congress to encourage exports by providing preferential tax treatment to income from export sales. The issue here implicates two of the fundamental principles upon which all of these statutory regimes have been premised. First, in determining how to calculate the income that qualifies for tax benefits, expenses are to be deducted from the gross income to which those expenses are *factually related*. Second, taxpayers have wide latitude to maximize the tax benefits with the least disruption of their business practices, and to that end each taxpayer may choose to calculate its in-

come and related expenses on the basis of either specific transactions or transaction groupings along product lines.

The decision below departs sharply from both of these principles. Under the rule announced by the Ninth Circuit, every taxpayer must allocate research and development ("R&D") expenses according to mandatory and extraordinarily broad product groupings that may bear no relation to the product groupings the taxpayer has chosen, resulting in the deduction of product-specific R&D expenses from export sales income that is attributable to other products and *not* factually related to those expenses. In this case, the court of appeals' holding resulted in a reallocation of some $2 billion of petitioner Boeing's R&D costs, thereby increasing Boeing's tax liability by more than $400 million. This decision is inconsistent with the Internal Revenue Code and frustrates the congressional intent underlying a significant economic stimulus measure.

1. In 1971, Congress enacted a set of provisions that were designed "to provide tax incentives for U.S. firms to increase their exports," a program that was thought important both for its "stimulative effect" and "to remove a * * * disadvantage of U.S. companies engaged in export activities." H.R. REP. NO. 92-533, at 58 (1971). See *Caterpillar Tractor Co.* v. *United States*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). Under this program, corporations were permitted to create special subsidiaries known as "Domestic International Sales Corporations" ("DISCs"). Qualifying income from export sales made through DISCs received favorable tax treatment in the form of partial tax deferral. IRC §§ 991-997.[1] As a

[1] To obtain the tax deferral, a parent corporation sold its export goods to its DISC subsidiary at a discount price, thereby assigning a portion of its otherwise taxable export income to the DISC. The parent then was taxed only on the income it retained and a specified portion of the DISC's income. Tax was deferred on the

consequence, "[t]he greater the DISC profit, the larger the amount of tax-deferred income * * *. Thus, a [corporation creating a DISC] had an incentive to maximize DISC profit." *St. Jude Medical, Inc.* v. *Comm'r*, 34 F.3d 1394, 1397 (8th Cir. 1994).

In 1984, in response to complaints from some of our country's trading partners, the DISC regime was replaced by one making use of Foreign Sales Corporations ("FSCs"). See Deficit Reduction Act of 1984, §§ 801-805, Pub. L. No. 98-369, 98 Stat. 494 (July 18, 1984). After FSC also was held to violate global trade rules, Congress responded by enacting the Extraterritorial Income Exclusion Act of 2000 ("ETI"), Pub. L. No. 106-519, § 3, 114 Stat. 2423 (Nov. 15, 2000). Each of these programs differs slightly from its predecessor, but none of the differences is relevant to the issue presented in this case. In all three of the statutory regimes, the mechanics of determining tax-favored income are substantially identical; in particular, each regime requires the allocation of expenses to factually-related export income and affords taxpayers broad flexibility to make these calculations based either on individual transactions or on various types of product lines.[2]

DISC's remaining income. See IRC §§ 991, 995. In 1984, Congress granted complete exemption from taxation to all DISC income that had not yet been taxed at that time. See Deficit Reduction Act of 1984, § 805(b)(2), Pub. L. No. 98-369, 98 Stat. 494 (July 18, 1984).

[2] The years at issue in this case involve the DISC and FSC provisions. Because the parties have agreed that there are no differences between DISC and FSC that are relevant to this case, we limit our discussion to DISC and refer to the Internal Revenue Code (26 U.S.C.) as in effect in 1979, unless otherwise indicated. The court below did this as well. See Pet. App. 6a n.3.

All three statutes give taxpayers alternative means of determining the portion of export income that qualifies for the favorable tax treatment. Section 994(a) of the DISC statute, which is representative in this respect of the FSC and ETI statutes as well, "permitted a taxpayer to use one of three methods for determining the amount of deemed profit allocated to the DISC and its parent as a result of export sales. The taxpayer/parent could choose the method resulting in the greatest amount of profit [for the DISC]." *St. Jude Medical*, 34 F.3d at 1397 (citations and footnote omitted). See H.R. REP. NO. 92-533, at 59 ("[s]pecial pricing rules in the bill permit a DISC to earn a larger relative amount of the profits arising on sales by the DISC of its parent company's export products").[3] One of these methods, which was used by petitioner Boeing in this case, is known as the "combined taxable income" (or "CTI") method. IRC § 994(a)(2). The CTI method permitted a DISC to retain 50 percent of "the combined taxable income of [the] DISC and [its parent corporation] which is attributable to" export sales. *Ibid.*[4]

The manner in which expenses are to be attributed to (and thus deducted from) export sales to determine combined taxable income is addressed in detail in the legislative history of the DISC statute and in regulations prescribed by the Secretary of the Treasury to implement the statute. Both congressional committee reports accompanying the DISC statute explain that, for purposes of determining CTI, Congress envisioned two types of expenses: expenses directly related to a particular transaction or product (or group of products), and

[3] See also IRC § 925(a) (FSC); IRC § 941(a) (ETI).

[4] The other two pricing methods assigned taxable income to the DISC equal to 4 percent of export gross receipts (IRC § 994(a)(1)) or in an amount based upon an arm's-length transfer price (IRC § 994(a)(3)).

expenses not directly related to any transaction or product. CTI was to be calculated by deducting from export gross receipts [1] "*all* expenses *directly related*" to the transaction or product and [2] "*a portion* of the * * * expenses *not allocable to any specific item of income*, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the [parent corporation] and the DISC." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107-08 (1971) (emphasis added). Congress thus intended that, in determining CTI for purposes of export tax benefits, expenses that were specifically related to certain items of income would be allocated only to those items, and expenses not related to *any* particular item of income would be apportioned among all items of income.

This directive was implemented by the Treasury Department's DISC regulations, which define CTI as "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC and [its parent corporation] * * * *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations provide specific guidance on how to conduct this calculation, explaining that costs

> which shall be treated as relating to gross receipts from sales of export property are *(a)* the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and *(b)* a ratable part of other expenses, losses, or other deductions which are *not definitely related to a class of gross income*, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

The cross-reference in the DISC regulations to Treas. Reg. § 1.861-8 also grew out of the statutory background.

The congressional committee reports explain that CTI is to be determined "generally in accordance with the principles applicable under [IRC] section 861," a statutory provision that sets out general rules for classifying revenue as either U.S. or foreign source income for U.S. income tax purposes. H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107.[5] As the reports emphasize, these "sourcing" rules determine the net income from a given source by "generally allocat[ing] to each item of gross income all expenses *directly related* thereto, and then apportion[ing] other expenses among all items of gross income on a ratable basis." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). Treas. Reg. § 1.861-8, which is cited in the DISC cost allocation regulation, "provided specific guidance for applying the allocation and apportionment rules referred to in IRC §§ 861, 862, and 863." *St. Jude Medical*, 34 F.3d at 1398. At the time the DISC legislation was enacted, Treas. Reg. § 1.861-8 "reiterated [IRC] § 861(b)'s language." *Id.* at 1402. See Treas. Reg. § 1.861-8 (1957).

The DISC regulations also establish the procedures by which taxpayers may make DISC income determinations, including the calculation of CTI, on either a transaction-by-transaction basis or, "at the annual choice of the taxpayer[,] * * * on the basis of groups consisting of products or product lines." Treas. Reg. §1.994-1(c)(7)(i). If a taxpayer chooses to

[5] IRC § 861(a) identifies income that is United States source gross income, while IRC § 861(b) provides for determining net, taxable U.S. source income by subtracting from gross income "the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income." The language of IRC § 861(b) has remained substantively unchanged since it was enacted as § 217(b) of the Revenue Act of 1921, ch. 136, 42 Stat. 227, 244 (1921).

group transactions, its choice of a "product or a product line *will be accepted*" by the IRS so long as it conforms *either* to "recognized industry or trade usage" or to "the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification [SIC] * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii) (emphasis added).[6] Thus, "[t]he taxpayer's choice [as to grouping] * * * shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

Accordingly, when a taxpayer chooses to group its export sales by product line, costs that definitely relate to any particular product group must be specifically allocated to the sales income of that group, while costs that do not definitely relate to any particular product group must be apportioned among all relevant classes of income. Costs that relate to a particular product group may *not* be allocated to any other product group, on a pro rata basis or otherwise. These grouping procedures were specifically contemplated by Congress. See H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 108 ("Although * * * the pricing rules provided by the bill gener-

[6] The Standard Industrial Classification is a system "used to categorize industries. Facilities may be categorized into major groups (2-digit SIC Code), industry groups (3-digit SIC Code), or industry codes (4-digit SIC Code), depending on the level of detail appropriate." *Nat'l Mining Ass'n* v. *U.S. E.P.A*, 59 F.3d 1351, 1355 n.6 (D.C. Cir. 1995) (citing EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 12 (1987)).

ally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.").[7]

2. The dispute now before the Court stems from a provision added to the IRC § 861 sourcing regulations in 1977, six years after enactment of the DISC statute and two years after issuance of the final DISC regulations in 1975. As a general matter, the 1977 revision of Treas. Reg. § 1.861-8 continued to "emphasize the factual relationship between the deduction and a class of gross income." Treas. Reg. § 1.861-8(b)(1). In

[7] To illustrate, suppose that Megacorp, a U.S. conglomerate, makes and sells $100 worth of space shuttles, $100 worth of motor scooters, and $100 worth of blimps during a particular year. All of the space shuttles are sold domestically to NASA, and all of the motor scooters and blimps are exported through Megacorp's DISC. During the same year, Megacorp spends $30 to research fuel alternatives for its space shuttles, $10 to research scooter wheel technology, nothing for blimp research, and $20 attempting to develop a new automobile that would recycle engine exhaust. Megacorp also has $15 in deductible charitable contributions. Under the DISC regulations, Megacorp can treat each of its four existing or nascent products as a separate group and calculate its total DISC income by adding up the separate net income (*i.e.*, CTI) attributable to its exported scooter and blimp groups. It does that by allocating its "definitely related" $10 of scooter R&D exclusively to its scooter group sales. Megacorp's other R&D costs, for space shuttles and automobiles, are not relevant to the CTI calculations, because all of these costs "definitely relate" to existing or future products that Megacorp's DISC does not sell. Its charitable deductions, which are not definitely related to any particular category of income, are apportioned among *all* categories of income pro rata based on sales. Therefore, the CTI amounts from scooters and blimps are each reduced by $5 ($15 x $100/$300). Ignoring Megacorp's other costs, scooter CTI is thus $85 ($100 minus $10 minus $5), blimp CTI is $95 ($100 minus $5), and total CTI is $180.

a significant departure from this principle, however, Treas. Reg. § 1.861-8(e)(3) announced a special and inconsistent rule for the allocation of research and development expenses.

The 1977 regulation provides that R&D expenses, even if directly related to *one particular product or product line*,

> shall ordinarily be considered deductions which are definitely related to *all* income reasonably connected with the relevant broad [two-digit SIC Code] product *category* * * * of the taxpayer and therefore allocable to *all* items of gross income * * * related to such product category[.]

Treas. Reg. § 1.861-8(e)(3) (1977) (emphasis added).[8] This regulation thus "deemed a definite relationship [to exist] between an expenditure for R&D and *all* income reasonably connected with a specific *broad product category*" (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D expense. To offer an example, under this new approach to allocation, income from the export of cotton balls would be reduced by R&D expenses related to the development of cardiac pacemakers and space suits, because all of those products are listed in SIC Code 38.[9]

[8] The provisions of Treas. Reg. § 1.861-8(e)(3) were renumbered in 1996 and, with amendments not relevant to this case, were republished as Treas. Reg. § 1.861-17. See Pet. App. 9a n.7.

[9] Again consider Megacorp. Because all of Megacorp's diverse R&D pertains to products falling within SIC classification 37, which broadly covers all "transportation equipment," Treas. Reg. § 1.861-8(e)(3) would place the entirety of that R&D into a single pot and apportion the undifferentiated sum among all products in proportion to current sales. Thus, the exported scooters and blimps each would attract $20 of R&D (total R&D of $60 x $100/$300), the CTI deemed attributable to each of those product groups would

3. For over 40 years, petitioner Boeing has been a world leader in commercial aircraft development and a major U.S. exporter of commercial aircraft. During the period at issue in this litigation, DISC-eligible export sales constituted approximately 70 percent of Boeing's commercial-aircraft sales by dollar volume. Boeing exported commercial aircraft through a qualified export subsidiary. Before 1985, that subsidiary was Boeing International Sales Corporation, a DISC; during the remaining years involved in this case, that subsidiary was Boeing Sales Corporation, a FSC.

Boeing has maintained its leadership position by continuously developing new commercial aircraft. Consistent with industry practice, Boeing organizes its internal operations along product lines (*e.g.*, aircraft models 727, 737, 747), each of which constitutes a separate "Program" within the Boeing organization. Management and staff for each Program are responsible for developing and managing a particular product line, including the line's various models and derivatives (for example, passenger and cargo versions of the 747). Pet. App. 16a.

As a leader in aviation technology, Boeing spends billions of dollars on research and development. Boeing allocates its R&D costs both *across* airplane Programs and directly *to* particular Programs, depending on the type of research. Some of Boeing's research is broad-based and aimed at generally advancing the state of the art for commercial aviation technology, including avionics and aerodynamics

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be $75 ($100 minus $20 minus $5), and total CTI would be $150 – in contrast to the $180 of total CTI that would result from applying the DISC regulations. This difference occurs because Treas. Reg. § 1.861-8(e)(3) mechanically reassigns to *all* products in SIC Code 37 portions of Megacorp's R&D that in fact are "definitely related" to *particular* products.

research. Boeing also conducts research to create and develop new products. Such research includes, for example, sketching and analyzing alternative fuselages, wings, and engines, as well as other technologies that could eventually be configured into a new commercial aircraft. Boeing refers to both of these types of research and development as "Blue-Sky R&D." Pet. App. 2a-3a, 16a-17a.

In addition to this Blue-Sky R&D, Boeing engages in extensive R&D for each *particular* product line or type of aircraft that the company has decided to produce. Research and development to design, develop, test, and qualify the new aircraft for commercial service is a major component of each Program. For example, because each new aircraft has a unique configuration, Boeing engineers must specially design thousands of parts to fit the new aircraft's configuration and aerodynamic requirements. Similarly, Boeing must conduct extensive research and testing to ensure that a new aircraft will meet national and international safety standards. Finally, Boeing regularly engages in R&D to modify and improve each product line even after aircraft within that product line have entered commercial service. Research directly related to particular Programs constituted over 75 percent of Boeing's total R&D expenditures for the years at issue in this litigation. Boeing refers to the *Program-specific* research and development as "Program R&D" because it is generally not transferable to other Programs or aircraft. Pet. App. 3a, 17a.

Boeing's cost accounting system has operated in essentially the same way since the 1960s, having been designed to comply with the Government Cost Accounting Standards and Federal Acquisition Regulations applicable to federal procurement programs. See CA9 Supp. E.R. 22. Mirroring its internal organizational structure, Boeing's accounting system tracks costs and revenues along Program lines. Each airplane Program is a separate "final cost objective," and the account-

ing system allocates to each Program those costs directly related to it. The same is true for revenues. So, for example, the costs and sales of the 727 are accounted for separately from those of the 767, which are accounted for separately from those of the 777. In keeping with this framework, Boeing's cost accounting system allocates all Program R&D to the particular product line to which it is related. Blue-Sky R&D, which relates to all Programs, is allocated to, and apportioned among, the Programs. For financial accounting and federal income tax purposes, Boeing deducts all research and development costs in the period in which they are incurred, even if there are no corresponding sales in that period. Pet. App. 3a, 17a; see also IRC § 174.

For DISC purposes, Boeing chose the CTI method to calculate income from export sales. Because the DISC regime permitted CTI to be determined for product groupings based upon recognized industry classifications, Boeing chose to treat each of its Programs as a DISC product grouping and derived the CTI for each grouping under the accounting procedures described above. So, for example, Boeing took the export sales receipts for a particular product line (*e.g.*, 737, 747) in one year and subtracted from that figure the costs associated with that product line in the same year, along with appropriate portions of costs not associated with any particular product line. Pet. App. 3a, 17a.

4. After examining Boeing's tax returns for the years at issue (1979-1987), the IRS disallowed Boeing's method of allocating its R&D costs to the Programs to which they factually related and instead reallocated those expenses pursuant to the special method described in Treas. Reg. § 1.861-8(e)(3), the sourcing R&D regulation that had been promulgated in 1977. Because all of Boeing's various commercial product lines fell into SIC Code 37 (transportation equipment), the IRS's approach deemed *all* of Boeing's R&D in

any given year – including R&D that unquestionably related only to one specific airplane model – to be related fungibly to sales of *all* airplane models in that year. The IRS therefore treated all R&D costs the same, without regard to whether the costs were demonstrably related as a factual matter to a particular product line.

For example, the IRS allocated a portion of the Program R&D costs specifically attributable to aircraft still in the developmental stages (as was the 767 during some of the years at issue) among aircraft produced by other Programs that were actually in production and being sold (such as the 747). The IRS allocated costs in this manner even though the R&D expenditures associated with developing a new product line (such as the 767) and bringing it to market did not in any way contribute to the development of existing product lines (such as the 747). By reallocating $2 billion of research and development costs, the IRS decreased the profits of Boeing's export subsidiaries and thereby increased Boeing's overall tax obligation for the years 1979 to 1987 by some $419 million. Pet. App. 3a-4a, 18a.

5. Boeing paid the additional tax demanded by the IRS and filed suit seeking a refund. The district court ruled for Boeing, holding that Treas. Reg. § 1.861-8(e)(3) is invalid as applied to CTI computations. Pet. App. 15a-24a. Relying on *St. Jude Medical, Inc.* v. *Commissioner*, *supra*, in which the Eighth Circuit rebuffed the IRS's attempt to apply Treas. Reg. § 1.861-8(e)(3) to the calculation of CTI, the district court pointed to two considerations supporting this conclusion.

First, the district court explained that, by mandating that R&D costs be grouped according to broad SIC classifications, Treas. Reg. § 1.861-8(e)(3) conflicts with Treas. Reg. §§ 1.994-1(c)(6)(iv) and (7), which provide that, for DISC purposes, taxpayers may group income and allocate costs by

product or product line. Pet. App. 21a-22a. Second, the court reasoned that Treas. Reg. § 1.861-8(e)(3) creates an artificial "deemed" relationship between sales and R&D that conflicts with Congress's intent to "'generally allocate to each item of gross income all expenses *directly related thereto*.'" Pet. App. 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H.R. REP. NO. 92-533, at 74)) (emphasis in *St. Jude Medical*). The district court thus concluded that the IRS erred in applying Treas. Reg. § 1.861-8(e)(3) to Boeing's CTI calculations, holding that Boeing was entitled to group its export sales by product line and allocate research and development expenditures accordingly.

The Ninth Circuit reversed. Pet. App. 1a-14a. The court of appeals opined that Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c)(7)

> can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3).

Pet. App. 12a. The court of appeals also reasoned that application of Treas. Reg. § 1.861-8(e)(3) in this context is supportable because, at the time of the enactment of the DISC statute, "Congress recognized that some of the costs incurred in a given tax year would not be 'directly related' to specific income items." Pet. App. 11a. The court therefore held that, as applied in this case, "Treas. Reg. § 1.861-8(e)(3) * * * is a reasonable interpretation of the applicable statutes and regulations." Pet. App. 13a. In reaching this conclusion,

the court expressly "decline[d] to follow the reasoning of [the Eighth Circuit in] *St. Jude Medical*." *Id.* at 10a.[10]

SUMMARY OF THE ARGUMENT

A. The Ninth Circuit's decision must be set aside because it is inconsistent with a fundamental principle governing the computation of DISC combined taxable income: costs that are factually related to one product (or product group) may not be deducted from revenue arising from the sale of a different product (or product group). That rule is established by the plain language of the DISC statute, which defines CTI as income that is "attributable to" export receipts. Income from the sale of one product can hardly be "attributable to" expenses relating to the development of an entirely unrelated product.

Moreover, the DISC statute was enacted against the backdrop of IRC § 861(b), a provision that had long required the factual matching of income and expenses. There is no doubt that Congress intended this longstanding § 861 principle to apply in the DISC context: Congress made that point explicitly in the DISC statute's legislative history. Indeed,

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[10] Unlike a DISC, which is completely exempt from taxation (IRC § 991), a FSC is exempt from taxation only on a specified percentage of its income. IRC §§ 882(a), 921(d), 923(a). Under the FSC statutory mechanism, the district court's holding, which enlarged CTI and thus the income of Boeing's export subsidiaries, automatically caused the tax liability of Boeing's FSC subsidiary to increase. Therefore, consistent with its reversal of the district court's holding for Boeing, the Ninth Circuit also reversed the district court's order increasing the tax obligation of Boeing's FSC. See Pet. App. 2a n.1. The government filed a conditional cross-petition (No. 01-1382), asking that, if the Court rules for Boeing on its petition (No. 01-1209), it require Boeing's FSC to pay this additional amount. Petitioners agree that if they prevail in No. 01-1209, the government should prevail in No. 01-1382.

the tax-writing committees restated the core principle of IRC § 861 in their own words, explaining that expenses that are directly related to particular property should be allocated only to revenues from *that* property. And this requirement is unambiguously confirmed by the DISC regulations that were promulgated by the Treasury Department almost contemporaneously with enactment of the DISC statute; those regulations provide that expenses "directly related" to particular products may not be deducted from receipts generated by the sale of other products.

In these circumstances, the Ninth Circuit erred in holding that, for DISC purposes, Treas. Reg. § 1.861-8(e)(3) could validly be applied to require that R&D expenses related to one product be deemed related to *all* income from *all* products within a broad SIC Code. That requirement attributes such R&D costs to income from the sale of products that had no factual connection to the R&D. It therefore departs from the manifest congressional intent.

B. The conflict between Treas. Reg. § 1.861-8(e)(3) and the intent of Congress underlying the DISC legislation is all the more apparent in light of a second important feature of the DISC regime: taxpayers may choose whether income determinations, including the computation of CTI, are to be made on a SIC Code product-grouping basis, on a recognized industry product-grouping basis, or on a transaction-by-transaction basis. The DISC regulations promulgated shortly after enactment of the DISC statute are unambiguous in giving taxpayers the virtually unrestricted right to decide whether and how to group their products.

Accordingly, if a taxpayer exercises its right to perform CTI calculations on a recognized industry product-grouping or specific-transaction basis, the DISC regulations require that all costs factually related to each chosen industry grouping or transaction be assigned to that grouping or transaction

alone – and not be reassigned to other groupings or transactions according to SIC Codes. These regulations implement one of numerous choices that Congress offered taxpayers in an effort to make the export incentive easy to use and therefore as effective as possible. The Ninth Circuit's holding undercuts this vital ingredient of the statute's design by compelling allocation of R&D on the basis of unbending product classifications defined by SIC Codes.

ARGUMENT

The statutory background here is complex, but the issue before the Court is simple and straightforward. May the IRS require allocation of product-specific R&D expenses to DISC income derived from product lines that are wholly unrelated to the underlying R&D activity? In our view, the answer to this question is clear. Every indicium of congressional intent – the plain language of the DISC statute, the background of existing legislation against which that statute was enacted, the DISC statute's explicit legislative history, the contemporaneous regulations interpreting the statute, and the unmistakable statutory policy – points in a single direction: in the computation of DISC income, product-specific costs must bear a factual relationship to the revenues from which they are deducted, and taxpayers are entitled to choose the method by which they group income and expenses.

The decision below is wholly inconsistent with both of these principles. Under the Ninth Circuit's holding, R&D costs related to the development of an improved cotton ball *must* be deducted from DISC income derived from the sale of space suits because both products happen to be listed in the same broad SIC Code. Needless to say, this requirement makes product-specific costs deductible from factually unrelated income, while also impinging on taxpayer flexibility in the grouping of transactions. Congress manifestly did not contemplate such an outcome when it enacted the DISC stat-

ute for the purpose of encouraging U.S. exports. As a consequence, application of the Ninth Circuit's approach "thwart[s] Congress's intent when it promulgated" the DISC regime and "is unreasonable, and thus invalid, as applied to DISC CTI computations." *St. Jude Medical*, 34 F.3d at 1402-1403.

A. Under The DISC Regime, Costs That Are Directly Related To Particular Income Must Be Allocated Exclusively To That Income

1. *The plain language of the DISC statute precludes the allocation of product-specific costs to unrelated income.*

At the outset, the Ninth Circuit's approach, which assigns costs that are factually associated with specific products to revenues from *other* products, simply cannot be reconciled with the controlling statutory language. The Code specifies that a DISC's net income, under each of the three methods of determining income permitted by the statute, is to be that "attributable to [a] sale" of export goods. IRC § 994(a). Speaking to the CTI method in particular, the statute, using similar language, goes on to provide that the income qualifying for export incentives is a specified portion of combined taxable income "attributable to the qualified export receipts." IRC § 994(a)(2).

The taxable income "attributable to" any sale necessarily consists of the gross revenue attributable to the sale less the expenses attributable to that revenue. As this Court has explained, in the tax context the "ordinary meaning [of] the phrase 'attributable to' [is] caused or generated by." *Braunstein* v. *Comm'r*, 374 U.S. 65, 70 (1963).[11] Therefore, the

[11] See also 1 OXFORD ENGLISH DICTIONARY 774-775 (2d ed. 1989) ("attributable" defined as "[c]apable of being attributed or ascribed, *esp.* as owing to, produced by"; verb "attribute" defined as "[t]o ascribe *to* as belonging or proper; to consider or view as belonging or appropriate *to*"); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 141-142 (1993) ("attributable" defined as "capable of being attributed"; verb "attribute" defined as "to explain as caused or brought about by: regard as occurring in consequence of or on account of").

language of IRC § 994(a) necessarily means that combined taxable income is the revenue generated by a sale minus the expenses that made that revenue possible – that is, the expenses that are factually related to the sale. In contrast, it is impossible to see how income from the sale of one product (*e.g.*, a Boeing 747) is, within the common usage of the words, "attributable to" factually unrelated expenses (*e.g.*, research costs relating to blimps).

Indeed, although Congress intended taxpayers to have discretion to calculate CTI for aggregations of transactions (see pages 6-8, *supra*), the default case described in the statute calls for CTI to be determined separately for each *individual* "sale of export property." See IRC § 994(a); H.R. REP. NO. 92-533, at 74. The CTI from any particular sale plainly was to be the revenue from that sale less the combined deductions of the DISC and its parent corporation attributable to the sale. Given the statutory text, it would be nonsensical to suggest that CTI was to be the revenue from the individual sale less some contrived quantum of deductions attributable partly to the particular sale in question and partly to completely unrelated sales.

Against this background, the Ninth Circuit plainly erred in holding that Treas. Reg. § 1.861-8(e)(3) could validly be applied in the circumstances of this case. Needless to say, the interpretation of a statute begins with the ordinary or natural meaning of the words used. *Federal Deposit Ins. Corp.* v. *Meyer*, 510 U.S. 471, 476 (1994); *Comm'r* v. *Soliman*, 506

U.S. 168, 174 (1993). If that meaning is clear, there is no need to look further. *Gitlitz* v. *Comm'r*, 531 U.S. 206, 220 (2001); *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 254 (1992). And here, the Ninth's Circuit's approach is precluded by the plain statutory language: subtraction of product-specific research and development costs from income generated by the sale of an *unrelated* product or group of products will result in a sum that cannot be said, in any ordinary sense, to be "attributable to" that sale.

2. The statutory background and legislative history confirm the plain meaning of the statute.

This common sense reading of the DISC statute's text is confirmed by an examination of the legislative context and history. As we have noted (at page 6, *supra*), IRC § 994 was enacted against the background of existing IRC § 861, a provision that determines the geographic source of several common types of income. IRC § 861(a) establishes source rules for various items of gross income, while § 861(b) dictates how deductible costs are to be assigned to those items of gross income to permit computation of net income. The latter provision, which had been in effect without substantive change for 50 years at the time the DISC statute was enacted, provided:

> From the items of gross income specified * * * there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*.

IRC § 861(b) (emphasis added). Plainly, this regime postulates that, if an expense *can* "definitely be allocated to some item or class of gross income," it falls into the first of these

categories and therefore may *not* be ratably apportioned across all classes of income.

Consistent with this principle, the § 1.861-8 regulations issued by the Treasury Department in 1957 (and in effect when the DISC statute was enacted in 1971) "reiterated § 861(b)'s language." *St. Jude Medical*, 34 F3d at 1402. Subsequent proposed regulations applying IRC § 861 that were published in 1966 spelled out the necessary implication of IRC § 861(b)'s text, explicitly providing that a "deduction which is definitely related to a single item or class of gross income *shall be allocated thereto*." Prop. Treas. Reg. § 1.861-8(a)(2)(i) (1966), 31 Fed. Reg. 10,394, 10,405 (Aug. 2, 1966) (emphasis added). This proposed regulation confirmed that a deduction was "definitely related" to gross income if it was "incurred in whole or in material part as a result of, or incident to, the activities from which such gross income is derived." *Id.* at § 1.861-8(a)(3)(i). Thus, the 1966 proposed regulation articulated the established § 861 principle that expenses incurred in connection with particular income must be traced and allocated exclusively to that definitely related income.

Congress unquestionably was aware of this longstanding principle in 1971 and intended it to apply in the DISC context. In their reports accompanying the DISC legislation, both of the congressional tax-writing committees specified:

> [T]he combined taxable income from the sale of the export property is to be determined generally *in accordance with the principles applicable under section 861* for determining the source (within or without the United States) of the income of a single entity with operations in more than one country.

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). In addition, the committees clearly stated

their understanding of the § 861 principles they were incorporating:

> These [§ 861] rules generally allocate to each item of gross income *all* expenses *directly related thereto*, and then apportion *other* expenses among all items of gross income on a ratable basis.

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added).

To make certain that there could be no misunderstanding of their intentions, the drafters went on to explain how these § 861 principles would apply to the determination of CTI:

> [T]he combined taxable income of a DISC and [its parent company] with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the * * * expenses of both the DISC and the [parent company] *which are directly related* to the production or sale of the export property and *a portion* of the * * * expenses not allocable to *any* specific item of income[.]

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). This system plainly leaves no room for taking expenses that are in fact related to particular export property and apportioning them to income from the sale of other, unrelated property.

3. The DISC regulations implemented Congress's expense-tracing mandate.

This understanding also is confirmed by the DISC regulations that the Treasury Department promulgated shortly after enactment of the DISC statute – regulations that "have particular force" because they were "a substantially contemporaneous construction of the statute by those presumed to have

been aware of congressional intent." *Nat'l Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979). These regulations provide that CTI is "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC and [its parent corporation] *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations then spell out expressly that the costs "relating to gross receipts" are:

> (a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and (b) *a ratable part* of any other expenses, losses, or other deductions *which are not definitely related to a class of gross income*[.]

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

In fact, this was the Treasury Department's view of the proper interpretation of the DISC statute virtually from the moment of enactment. In the Technical Memorandum accompanying issuance of the proposed DISC regulations in 1972,[12] the Treasury Department explained:

> Under these rules, generally, expenses which are definitely related to particular items of income are taken into account only with respect to such items. * * * Rules are also provided to make clear that only

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[12] The 1972 proposal was, for all purposes relevant to this case, virtually identical to the final regulations adopted in 1975. The only difference of note is that, while the 1972 proposed regulations referred to expenses attributable to specific income items as costs "properly apportioned and allocated" to gross receipts, the 1975 final regulations cemented the intended concept by referring to such expenses as costs "*definitely related*, and therefore allocated and apportioned," to gross receipts. Prop. Treas. Reg. § 1.994-1(c)(6)(iii) (1972), 37 Fed. Reg. 19,265, 19,266 (Sept. 21, 1972); Treas. Reg. § 1.994-1(c)(6)(iii) (1975).

> items attributable to the transaction are taken into account in computing "taxable income" of the DISC. *Thus, loss items cannot be netted against gain items unless they are from the same transaction, or in the case of a grouping election under paragraph (c)(7), are part of the same product or product line.*

1972 T.M. Lexis 14, *9 (June 29, 1972) (emphasis added). It thus was clearly understood that expenses related to particular products may *not* be offset against income from the sale of other products.

To be sure, the final DISC regulation issued in 1975 provides that costs are to be allocated to CTI "in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii). As we have explained (at page 6, *supra*), however, the version of Treas. Reg. § 1.861-8 contemporaneously in force when the DISC regulations were promulgated simply reiterated IRC § 861(b)'s language, distinguishing between expenses that may and may not "definitely be allocated" to a class of income. And a proposed revision to the § 1.861-8 regulations that was published in 1973[13] – and was still pending in 1975, when the DISC regulations became final – unambiguously applied this factual relationship principle to R&D in the DISC context.

Those 1973 proposed § 861 regulations set forth the general rule as follows:

> Expenditures for research and development which a taxpayer deducts * * * shall be considered deductions which are *definitely related* to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class.

[13] The 1973 proposed regulation expanded upon and replaced the 1966 proposed regulation described at page 21, *supra*.

Prop. Treas. Reg. § 1.861-8(e)(3)(i) (1973), 38 Fed. Reg. 15,840, 15,843 (June 18, 1973) (emphasis added). Example 1 in § 1.861-8(g) of this proposed regulation illustrated the rule by treating four-, six-, and eight-cylinder gasoline engines as separate products, each with separate and directly allocable R&D. Example 2 expressly applied this specific tracing of R&D in a DISC setting where the taxpayer had elected to treat four- and six-cylinder engines as separate product groups, necessitating separate CTI calculations for each group. R&D related to the eight-cylinder engines (a product line not sold through the taxpayer's DISC) was *not* used to offset income from sales of the four- and six-cylinder engines. The 1973 proposed regulations under IRC § 861 therefore reiterated the principle that taxpayers were "required to allocate deductions," including R&D deductions, "on the basis of the factual relationship of deductions to gross income." Prop. Treas. Reg. § 1.861-8(a)(2) (1973).

Indeed, the Treasury Department explicitly declined to include any expense allocation examples in the final 1975 DISC regulations precisely because it thought that these examples in the 1973 proposed IRC § 861 sourcing regulations were sufficient illustrations of how expenses were to be allocated for CTI purposes. According to the Technical Memorandum concerning the final DISC regulations, the Treasury Department had received complaints that the proposed CTI computation provisions lacked examples of how to allocate expenses. But

> [s]ubsequent to receipt of these comments, a notice was published under § 1.861-8 on June 18, 1973 (38 F.R. 15840) [*i.e.*, the 1973 proposed § 1.861-8 regulations] which provides rules and examples for allocation and apportionment of expenses in determin-

> ing combined taxable income of the DISC and related supplier. Hence, this suggestion [to add examples to the DISC regulations themselves] was not adopted.

1974 T.M. Lexis 30, *20-21 (Oct. 29, 1974). In the period immediately following enactment of the DISC statute, the Treasury Department thus expected that product-specific R&D would *not* be allocated to income from other products. As a consequence, the R&D allocation method used by Boeing is precisely the method anticipated both by Congress and by the drafters of the contemporaneous DISC regulations. [14]

4. Application of Treas. Reg. § 1.861-8(e)(3) to the determination of CTI conflicts with the DISC statute.

In this setting, the Ninth Circuit plainly erred in holding that the ultimate version of Treas. Reg. § 1.861-8(e)(3) – adopted years *after* the DISC statute and regulations were firmly in place – could validly be applied in the circumstances of this case. That regulation deems *all* R&D expenses to be definitely related to *all* income within a broad SIC

[14] In fact, aside from Treas. Reg. § 1.861-8(e)(3), the aberrational R&D provision at issue here, the § 861 Treasury regulations have themselves consistently recognized that the IRC § 861 regime contemplates a factual relationship between an expense and the class of income to which it is allocated. Treas. Reg. § 1.861-8(b) specifically notes that the allocation "rules emphasize the factual relationship between the deduction and a class of gross income." The preamble accompanying the proposal of the § 861 regulations on which the government relies in this case states: "If a proper allocation and apportionment of deductions *on the basis of factual relationships* is not accomplished, taxable income attributable to various sources will not be properly reflected under the applicable operative provisions of the Code." 41 Fed. Reg. 49,160, 49,161 (Nov. 8, 1976) (emphasis added).

Code, so that product-specific expenses must be spread over revenue from *other* products and product groups falling within that Code. By providing that "[e]xpenditures for research and development which a taxpayer deducts * * * shall ordinarily be *considered* deductions which are definitely related to *all* income reasonably connected with the relevant *broad product category*" (Treas. Reg. § 1.861-8(e)(3)(i)(A) (emphasis added)), the regulation eliminates any necessity for a factual connection between expenses and the income from which they are deducted.[15] Indeed, Treas. Reg. § 1.861-8 itself acknowledges that it departs from the "factual relation" principle with respect to R&D expenses, stating:

> The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that * * * the gross income derived from successful research and development must bear the cost of unsuccessful research and development.

Treas. Reg. § 1.861-8(e)(3)(i)(A).

[15] The abrupt about-face in the regulations' R&D allocation method is brought into sharp relief through a comparison of Example 2 in § 1.861-8 of the 1973 proposed regulations and Example 4 in § 1.861-8(g) of the 1977 final regulations. Example 2, it will be recalled, did not allocate the R&D expenses related to developing 8-cylinder engines to the revenues from the sales of 4- and 6-cylinder engines. See page 25, *supra*. In Example 4 of the 1977 regulations, on the other hand, R&D expenses related to bulldozer development were used to offset the revenues from both bulldozers *and* lawn mower engines because both fall within the same SIC Code. The 1977 Example 4 therefore ignores the factual connection between expenses and revenues that was central to the outcome in the 1973 proposed regulation's Example 2.

As the Eighth Circuit noted in striking down this regulation as applied to CTI calculations, this approach "*deem[s]* a definite relationship" to exist between an expenditure for R&D and *all* income associated with a broad product category (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D or how broad the product category. And these SIC Code product categories are very broad indeed; the regulation lists a scant 20 product categories for manufactured goods, into which all of the vast multitude of discrete products generated by the American economy must fall. See Treas. Reg. § 1.861-8(e)(3)(i)(A).

Not surprisingly, application of this regulation in the computation of CTI can lead to perverse results, as this case strikingly demonstrates. Under the court of appeals' holding, Boeing R&D that relates exclusively to *one* specific airplane model has to be allocated, in large part, to revenue from the sale of *other*, unrelated models. If Boeing incurred a research expense in 1987 that was directed solely to improving a component unique to a new 767 model that was not yet in production, the Ninth Circuit would require treating the expense as part of the cost of that year's sales of model 747 airplanes – even though the 747 had been introduced years earlier and did not benefit at all from R&D relating to the 767. By the same token, the court of appeals' holding would require that research costs from the development of hang gliders, blimps, or the recently announced "Sonic Cruiser" all be allocated, in part, to the revenue from the sale of 747s because they all fall within the SIC Code 37 ("transportation equipment").

For the reasons discussed above, application of this methodology in the DISC context is insupportable. The "deemed" relationship ignores the *actual* connection between expense and income, which Congress manifestly intended to

guide CTI calculations under the DISC statute. The Ninth Circuit's approach also cannot be squared with the contemporaneous regulations that the Treasury Department itself issued implementing that statute's terms.

In these circumstances, it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply at all to the computation of CTI. The Treasury Department evidently contemplated that there would be situations in which R&D expenses should not be deemed related to all income within an applicable SIC Code; Treas. Reg. § 1.861-8(e)(3)(A) provides that such treatment "[o]rdinarily" is appropriate, which of course suggests that there are some types of cases in which such treatment is *in*appropriate. This plainly is such a case. Because application of Treas. Reg. § 1.861-8(e)(3) cannot be squared with the DISC statute, that regulation should yield to the specialized DISC regulations that were specifically designed to govern the CTI determination. See *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992) ("it is a commonplace of statutory construction that the specific governs the general"); *Crawford Fitting Co.* v. *J. T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987) ("[w]here there is no *clear* intention otherwise, a specific statute will not be controlled or nullified by a general one") (citation and internal quotation marks omitted; alteration and emphasis supplied). But whether or not the drafters of Treas. Reg. § 1.861-8(e)(3) intended it to apply in cases such as this one, the outcome must be the same: the plain text of and manifest intent behind the DISC statute precludes use of the regulation's "deemed relationship" methodology in calculating CTI.

B. The DISC Statute And Regulations Allow Taxpayers To Choose Whether CTI Is Calculated On The Basis Of Industry Usage Rather Than SIC Code

1. The conclusion that product-specific expenses must be deducted from the DISC income to which they are factually related is enough to dispose of this case. But the Ninth Circuit's holding that CTI must be calculated by spreading R&D expenses across all products within a broad SIC Code is erroneous for a second, closely related reason: the DISC regulations emphatically state that the taxpayer is entitled to *choose* whether or not CTI determinations will be made on the basis of particular sales, on the basis of product groups recognized by industry usage, or on the basis of SIC Code product groups. That choice, once made, identifies the universe of sales income to which related expenses must be allocated. And the regulations establishing the primacy of taxpayer choice in this regard implement the clear congressional intent.

As we have noted (page 19, *supra*), the governing statutory provision calls for CTI to be determined separately for *each* "sale of export property." See IRC § 994(a). Needless to say, performing separate calculations of CTI for each individual export sale could severely burden the accounting resources of a large exporter, which may have many thousands of export sales every year. Undoubtedly mindful of this looming administrative hardship, the congressional tax-writing committees specified that, "[a]lthough both of the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 108. Indeed, Congress attached such importance to affording taxpayers product-grouping alternatives that it included provisions specifically authorizing grouping

in each successive export incentive enactment. IRC § 927(d)(2)(B) (1984) (FSC); IRC § 943(b)(1)(B) (2000) (ETI).

The Treasury Department faithfully implemented this congressional intent in the regulations issued shortly after enactment of the DISC statute. These regulations establish two product-grouping alternatives to transaction-by-transaction computations of CTI: "recognized industry or trade usage" groups *or* the "groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). The regulations then added even greater flexibility by permitting taxpayers to choose grouping selectively. Thus, "the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year." Treas. Reg. § 1.994-1(c)(7)(iii). Moreover, because grouping was "at the annual choice of the taxpayer" (Treas. Reg. § 1.994-1(c)(7)(i)), taxpayers could change their grouping decisions from year to year.

Because the purpose of grouping was to ease taxpayer burdens while allowing taxpayers to maximize their DISC tax benefits, the DISC regulations make explicit that the taxpayer has the right to select which of these grouping options to use. They state that a product grouping "determination by a taxpayer * * * *will be accepted* [by the IRS]" as long as the taxpayer's choice conforms either to recognized industry usage or to the SIC Code classifications referred to above. Treas. Reg. § 1.994-1(c)(7)(ii) (emphasis added). For good measure, the regulations provide that "[t]he taxpayer's choice [as to grouping] * * * shall be controlling." Treas. Reg. § 1.994-1(c)(6)(iv)(emphasis added).

2. The virtually unrestricted opportunity to choose product groupings is one of a raft of choices that the DISC program made available to taxpayers. Taxpayers were given

substantial leeway to determine for themselves how best to maximize their tax benefits, minimize their compliance burdens, and strike the balance between benefits and burdens. This broad flexibility was essential to making the DISC program effective as an export incentive. Thus, at every turn the congressional design enabled taxpayers free rein to make choices.

For example, although the statute generally contemplated that an exporter would sell its goods to its DISC, which in turn would resell them to the customer, Congress alternatively allowed taxpayers to continue making sales directly to their customers while paying their DISCs a sales commission. IRC § 994(b)(1). The regulations duly specify that an exporter would obtain an equal tax benefit under either export sales structure. See Treas. Reg. § 1.994-1(d)(2).

Similarly, Congress incorporated broad flexibility in a requirement (IRC § 992(a)(2)) that DISCs invest their tax-deferred earnings in assets relating to exports. The statute provides a long menu of qualifying investments, including inventories of goods to be exported, customer accounts receivable arising from export sales, certain loans for use in the parent corporation's export business, securities issued by the Export-Import Bank, and several others. IRC § 993(b); Treas. Reg. § 1.993-2. With all these choices, every taxpayer could comply with the statute's investment requirement in the manner best suited to its particular business.

In addition, as explained above, the statute permits taxpayers to maximize their DISC benefits by choosing from one of three alternative transfer pricing methods. IRC § 994(a). See page 4, *supra*. From among these options, taxpayers were free to "choose the method resulting in the greatest amount of profit" for the DISC. *St. Jude Medical*, 34

F.3d at 1397.[16] Because the various transfer pricing methods were available on a transaction-by-transaction basis (IRC § 994(a)), taxpayers also were free to apply any of the permitted pricing methods to certain sales while applying a different method or methods to other sales. Indeed, because the statute made DISC benefits available for individual transactions, an exporter was free to decline DISC benefits altogether for selected export sales.

This wide array of choices that Congress built into the DISC regime was critical to the achievement of the statute's function as a tax incentive. Congress's overriding goal was to provide a stimulus that would encourage as many companies as possible to increase their export sales, thus keeping domestic jobs from moving overseas. Although the statute promised significant tax benefits to that end, obtaining those benefits could impose a considerable cost: possibly undesirable structural changes to export businesses; greater compliance burdens; the inconvenience of interposing the DISC in the sales channel to the customer; and the enormous administrative difficulty of separately calculating the DISC benefit for potentially thousands of individual export sales every year. Had the statute been designed too inflexibly, these various disadvantages would have discouraged use of the incentive, thereby eroding its intended stimulative effect. But the

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[16] The three pricing methods also provided taxpayers with flexibility in determining to what extent they had to reorganize their business in order to take advantage of the DISC incentive. Normally, transactions between related parties are governed by the arm's length standard of IRC § 482, which assigns profits based on the relative economic functions of the parties. By providing two additional pricing options, Congress created additional flexibilty by relieving taxpayers of the burden of dividing the economic functions between the taxpayer and the DISC to justify the DISC's profit level. See Treas. Reg. § 1.994-1(a)(2).

DISC system's many compliance and benefit-calculation options, which vest wide discretion in the taxpayer, enabled each company to strike its own balance of burdens and benefits, thereby maximizing the nationwide effectiveness of the incentive. The broad range of taxpayer choice, of which the "grouping" regulation was an integral part, therefore was central to the fulfillment of Congress's principal objective.

3. Application of Treas. Reg. § 1.861-8(e)(3) in this setting clashes directly with the critical taxpayer-choice feature of the DISC regime. In this case, Boeing exercised its option to group its transactions by product lines that indisputably conform with recognized industry practice. But rather than allocate R&D costs to the classes of income "resulting from [the taxpayer's] grouping," as the DISC regulation mandates, Treas. Reg. § 1.861-8(e)(3) requires that such costs be allocated according to SIC Code – which is not, of course, the alternative that Boeing, exercising its unfettered discretion, decided to use.

The Ninth Circuit went fatally astray in endorsing this approach to the allocation of R&D in the DISC context. When a taxpayer makes a product-grouping choice, *all* of "the determinations under [Treas. Reg. § 1.994-1] are to be made * * * on the basis of" the taxpayer's chosen groupings. Treas. Reg. § 1.994-1(c)(7)(i). That is, *every* aspect of the calculation of CTI must be made in accordance with the groupings that the taxpayer has selected. Of course, the allocation of expenses to sales is one of those aspects and, as we have explained (pages 23-25, *supra*), the regulation expressly dealing with that matter (Treas. Reg. § 1.994-1(c)(6)(iii)) calls for expenses to be allocated to the sales that are factually related to those expenses. Consequently, when a taxpayer has decided to employ product groupings, expenses are to be allocated on the basis of their factual relationship to sales *within each chosen grouping*. The regulations spell out

this point as well. Treas. Reg. § 1.994-1(c)(6)(iv) ("costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from [the taxpayer's] grouping.").

As the Eighth Circuit accordingly explained in rejecting application of Treas. Reg. § 1.861-8(e)(3) in the computation of CTI, "*[m]andating* use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated [either] on a product-by-product basis *or* on the basis of product lines." *St. Jude Medical*, 34 F.3d at 1401 (emphasis added). The decision below thus works a significant, and unwarranted, change in Congress's carefully drawn balance of incentives and compliance requirements.

C. The Ninth Circuit's Reasoning Does Not Support Its Judgment

In nevertheless requiring the allocation and apportionment of R&D expenses on the basis of SIC Code when DISC CTI is calculated, the Ninth Circuit entirely failed to address the legislative and regulatory background. And the rationales that the court of appeals did advance cannot support its holding.

1. To begin with, after observing that IRC § 994(a)(2) required CTI "to be calculated based on revenue and costs 'attributable to' sales," the court of appeals noted that "[t]his statutory text does not confine the relevant costs to those 'definitely related' to sales of a particular product." Pet. App. 11a. That statement is unassailable; relevant costs also clearly include "a ratable part of any other [costs] which are not definitely related" to sales of *any* particular product. See Treas. Reg. § 1.994-1(c)(6)(iii). But it is undisputed in this case that the R&D costs that the IRS reallocated to Boeing's export sales *were* definitely related to particular products or product lines – products *that Boeing did not export*. The

court of appeals simply blinded itself to this incontrovertible fact. The court never even tried to explain how CTI amounts could possibly be "attributable to" the products that Boeing did export if those amounts were reduced by costs definitely related to products that Boeing did not export.

Nor did the Ninth Circuit explain why its holding was supported by the comment that "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." Pet. App. 11a. That observation, while also doubtless correct, is simply beside the point. That certain costs (*e.g.*, charitable contributions, see Treas. Reg. § 1.861-8(e)(9)) are not directly related to specific products hardly means that costs that *are* directly related to specific products should be apportioned to revenue from the sale of *other* products. The Ninth Circuit's sleight-of-hand thus cannot obscure its departure from the fundamental principles underlying the DISC statute and regulations.

The court of appeals made a related error in opining that Treas. Reg. § 1.861-8(e)(3) and § 1.994-1(c) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income." Pet. App. 12a. This perplexing statement disregards both the undisputed facts and the controlling law. As we have just explained, the statement is flatly wrong as a factual matter because the R&D costs for each Boeing Program were *definitely* related to that Program and that Program alone, and were completely *unrelated* – "indefinitely" or otherwise – to other Programs. The Ninth Circuit's statement is equally indefensible as a legal proposition, because Treas. Reg. § 1.861-8(e)(3)(i) manifestly did not transform any R&D expenses into costs "'indefinitely' related to specific items of income." To the contrary, the theory of the regulation is that

all R&D costs may be deemed "*definitely* related to all income reasonably connected with the relevant [SIC] category" (emphasis added). The Ninth Circuit's justification for its conclusion therefore is unsupported by the very provision it purports to interpret.

In fact, as we have noted, the default method of CTI computation is transaction-by-transaction. IRC § 994(a)(2); Treas. Reg. § 1.994-1(c)(7)(i) ("Generally, the determinations under this section are to be made on a transaction-by-transaction basis."); see also H.R. REP. NO. 92-533, at 74. Congress thus expected that DISC income very often would be calculated on the narrowest possible basis, that of individual sales. There is no indication that Congress expected this method of calculation to require the association of vast, "indefinitely related" costs with the sales revenue.

2. The court of appeals also may have meant to adopt the government's argument below (see U.S. 9th Cir. Br. 11) that it was impermissible for Boeing to allocate R&D expenses to Programs that had no current gross income from which those expenses could be deducted. See Pet. App. 3a (stating that such costs "simply 'disappeared'"). If so, the court plainly erred.[17] The reality is that the U.S. taxation sys-

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[17] We note that the government's own allocation method would not eliminate the phenomenon of "disappearing" R&D expenses. Take, for example, the case of a company currently producing and exporting athletic clothing (SIC Code 23) that decides to invest the proceeds of its clothing sales in research to develop a line of athletic equipment (SIC Code 39). The company has current DISC sales of $1,000,000 from the athletic clothing, no current sales of athletic equipment, and $500,000 in athletic equipment R&D expenses. Under the government's allocation method, the $500,000 of equipment-related R&D will be allocated to the athletic equipment SIC Code, which has no income. It will not be allocated to the athletic clothing SIC Code to reduce the income eligible for the

tem, with few exceptions, is based upon the annual accounting of revenue and deductible costs. See, *e.g.*, IRC § 441(a) ("Taxable income shall be computed on the basis of the taxpayer's taxable year."). See generally *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931); *Healy* v. *Comm'r*, 345 U.S. 278, 285 (1953).

The "disappearance" of R&D costs therefore is the *intended* consequence of another legislative tax incentive: Congress's decision to make R&D expenses currently deductible (see IRC § 174) so as "to encourage expenditure for research and experimentation." *Snow* v. *Comm'r*, 416 U.S. 500, 504 (1974) (citation and internal quotation marks omitted). R&D expenses are likely to exceed any income they generate during the early years in the development cycle of any product. By nonetheless authorizing the current-year deduction – rather than capitalization (see IRC § 263A(c)(2)) – of R&D expenditures, Congress authorized these expenditures to "disappear."

It therefore is not surprising that Treas. Reg. § 1.861-8 itself acknowledges that expenses incurred in one year may exceed the related income (if any) earned in that year. The regulation repeatedly and explicitly acknowledges that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class * * * *even though, for the taxable year, no gross income in such class is received.*" Treas. Reg. § 1.861-8(d)(1) (emphasis added); see also *id.* §§ (b)(1), (b)(2), (c)(1). Thus, the regulations under § 861 acknowledge and expressly countenance this temporal mismatch phenomenon.

What is more, the government's "disappearance" argument, if accepted, could greatly reduce the value of tax incen-

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DISC benefit related to the clothing. That expense accordingly will, in the Ninth's Circuit's words, "simply disappear."

tives aimed at increasing exports and encouraging long-term research on new programs. For example, if Boeing undertook development of a new product that would be of significant benefit to the country – such as the Sonic Cruiser – the enormous R&D expenses likely to be related to that product would reduce the export benefit from the unrelated current sales of commercial aircraft. The government's application of Treas. Reg. § 1.861-8(e)(3) therefore stands to penalize exporters who perform R&D on new products by diminishing the tax advantages related to their current exports. That result is clearly contrary to Congress's intention to create incentives for both exports and R&D.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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Nos. 01-1209 and 01-1382

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, CROSS-PETITIONER

v.

BOEING SALES CORPORATION, ET AL.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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6 APP

QUESTIONS PRESENTED

No. 01-1209

1. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1979-1984 under the provisions of the Internal Revenue Code pertaining to "domestic international sales corporations" (26 U.S.C. 991-997 (1976 & Supp. III 1979)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury Regulations.

2. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1985-1987 under the provisions of the Internal Revenue Code pertaining to "foreign sales corporations" (26 U.S.C. 921-927 (1988)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury Regulations.

No. 01-1382

3. Whether, if the judgment in No. 01-1209 is reversed, the judgment in favor of cross-respondent in No. 01-1382 should then also be reversed.

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In the Supreme Court of the United States

No. 01-1209

THE BOEING COMPANY AND
CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

No. 01-1382

UNITED STATES OF AMERICA, CROSS-PETITIONER

v.

BOEING SALES CORPORATION, ET AL.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 258 F.3d 958. The opinion of the district court (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001. A petition for rehearing was denied on November 19, 2001. The petition for a writ of certiorari was filed on February 15, 2002, and a conditional cross-petition was filed on March 20, 2002. Both were

granted on May 28, 2002. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 861 and 994 of the Internal Revenue Code, 26 U.S.C. 861 and 994 (1976 & Supp. III 1979), and of 26 C.F.R. 1.861-8 and 1.994-1 (1979), as they were in effect in the years relevant to this case, are set forth at Pet. App. 26a-53a. In addition to those provisions, the relevant portions of Sections 174 and 925 of the Internal Revenue Code, 26 U.S.C. 174, 925 (1988), of 26 C.F.R. 1.925(a)-1T (1989), and of 26 C.F.R. 1.861-17 are set forth at App., *infra*, 1a-12a.

STATEMENT

1. Congress has authorized the Secretary of the Treasury to prescribe regulations "to properly apportion[]" expenses in calculating income resulting from foreign sales of goods. 26 U.S.C. 863(a). This case concerns a challenge to the regulations adopted by the Secretary to properly allocate research and development costs under that statute. The question presented in this case arose under two separate sets of statutory and regulatory provisions, which have since been modified or repealed.

In 1971, Congress enacted provisions that established a separate tax status for "domestic international sales corporations" (DISCs). 26 U.S.C. 991-997 (1976 & Supp. III 1979). The DISC provisions sought to "provide substantial stimulus to exports and at the same time to avoid granting undue tax advantages." S. Rep. No. 437, 92d Cong., 1st Sess. 13 (1971). Under these provisions, a domestic manufacturer could form a DISC in the United States "the income of which is not taxed at the DISC level. Instead, the corporate shareholder was taxed directly on a portion of the DISC's

income deemed distributed. The portion of the income not deemed distributed was not subject to any U.S. taxation until actually distributed." R. Doernberg, *International Taxation* 395-396 (4th ed. 1999).[1]

b. Soon after their enactment, the DISC provisions were challenged by other Nations as impermissible export subsidies under the General Agreement on Tariffs and Trade. See R. Doernberg, *supra*, at 396. As a consequence, Congress replaced the DISC provisions in 1984 with the "foreign sales corporation" (FSC) provisions of the Code. 26 U.S.C. 921-927 (1988). See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b), 98 Stat. 1000-1001.[2]

Under the FSC provisions, a U.S. parent would establish a foreign subsidiary to conduct export sales.[3] "If a corporation qualifies as a FSC, a portion of its foreign trade income is exempt from the U.S. corporate income tax. That portion can be distributed as a dividend tax-free to the U.S. parent corporation * * * ." R. Doernberg, *supra*, at 397. To escape taxation entirely on the portion of the income allocated to the FSC, "many U.S. corporations organize FSCs in

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[1] This, at least, was the theory when the DISC provisions were enacted. When the DISC provisions were replaced in 1984, however, previously accumulated and undistributed DISC income was effectively exempted from tax in many cases. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b)(2)(A), 98 Stat. 1001.

[2] The DISC provisions were left in effect only "for small corporations" (with export receipts less than $10 million) and were revised to require the payment of interest on any deferred tax liability. 26 U.S.C. 995(b)(1)(E), 995(f) (1988).

[3] Unlike the DISC, the FSC is a foreign corporation, and a portion of its foreign trade income is subject to United States tax. 26 U.S.C. 921, 923. For this reason, Boeing Sales Corporation (petitioner's FSC) is a party to this case.

foreign countries imposing relatively low, or no, corporate and dividend withholding taxes on that income." *Ibid.*[4]

2. a. The DISC and FSC provisions "quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14, at 17-43 (4th ed. 1979); *id.* ¶ 17.14, at 17-55 (5th ed. 1987). The central feature of each regime is the allocation of the income resulting from export transactions between the parent and its sales subsidiary. In general, under these provisions, the parent has an incentive to maximize the portion of the profits from export sales allocated to its sales subsidiary, rather than to the parent, in order to defer (under the DISC) or exempt (under the FSC) that income from tax.

b. Under the DISC regime, the portion of the export income attributed to the DISC is based on an assumed "transfer price"[5] for the exported good that would allow the DISC to derive net income that does not exceed the

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[4] After the World Trade Organization concluded that the FSC provisions provided a prohibited export subsidy (World Trade Organization, Appellate Body, *United States—Tax Treatment for "Foreign Sales Corporations," Recourse to Article 21.5 of the DSU by the European Communities*, AB-2001-8, at 91-93 (Jan. 14, 2002)), Congress repealed and replaced the FSC provisions with the "extraterritorial income exclusion" of Section 114 of the Internal Revenue Code. 26 U.S.C. 114.

[5] The "transfer price" is the hypothetical price at which the good is assumed to have been transferred from the U.S. parent to its DISC or FSC. Once calculated under the DISC and FSC provisions, this price is used in allocating the net income from the transaction between the parent and its sales subsidiary. 26 U.S.C. 994(a); 26 U.S.C. 925(a).

greatest of (i) 4% of the export receipts, (ii) 50% of the "combined taxable income" of the parent and the sales subsidiary, or (iii) the income that would result from an arm's length sale price. 26 U.S.C. 994(a). The FSC regime has a similar profit allocation procedure. 26 U.S.C. 925(a) (1988). The DISC and FSC regulations permit the taxpayer to apply one transfer price method for one group of sales while applying a different transfer price method for another group of sales made during the same year. 26 C.F.R. 1.994-1(c)(7)(i) (DISCs); 26 C.F.R. 1.925(a)-1T(c)(8) (FSCs).

c. Petitioner elected to use the "transfer price" method that is based on the "combined taxable income" of the parent and the sale subsidiary for all of its groups of DISC and FSC export sales.[6] The specific questions addressed in this case concern the proper method for calculating "combined taxable income" under the governing regulations.

Congress did not define the term "combined taxable income" in either the DISC (26 U.S.C. 994(a)(2)) or the FSC (26 U.S.C. 925(a)(2) statutes. In enacting these provisions, however, Congress made clear that it intended that the term "combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable

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[6] As used in this brief, the singular "petitioner" refers to the parent corporation, The Boeing Company. Under the method used by petitioner, the transfer price is the price that would allow the DISC to derive income attributable to the sale of the property in an amount that does not exceed "50 percent of the combined taxable income of such DISC and [the parent] which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC." 26 U.S.C. 994(a)(2). The cognate rule for a FSC is found in Section 925(a)(2), which sets the limit at 23% of "combined taxable income." 26 U.S.C. 925(a)(2).

under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971).

Section 861, to which the DISC committee reports refer, distinguishes between United States and foreign source income for various income tax purposes.[7] Section 861(a) specifies a number of broad categories of gross income (such as interest from United States payers) that are treated as United States source income. 26 U.S.C. 861(a). Section 861(b) provides, in turn, that expenses "properly apportioned or allocated" to the items of United States source income specified in Section 861(a), along with a ratable portion of any expense that "cannot definitely be allocated" to an item of gross income, are to be deducted to arrive at United States source taxable income. 26 U.S.C. 861(b). Congress specified that the determination whether an expense is "properly apportioned or allocated" to an item of gross income for this purpose is to be made "under regulations prescribed by the Secretary [of the Treasury]." 26 U.S.C. 863(a), (b).

d. The regulations adopted by the Secretary to implement the DISC provisions track the legislative reports. 26 C.F.R. 1.994-1(c)(6) provides that the "combined taxable income" from a sale of export property "is the excess of the gross receipts * * * of the DISC from such sale over the total costs of the DISC and

[7] Whether income has a domestic or foreign source has importance for several purposes. The primary role of this determination is in the calculation of permissible foreign tax credits and the avoidance of double taxation of foreign source income. See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶¶ 17.10, 17.11, 17.30 (5th ed. 1987).

related supplier which relate to such gross receipts." Section 1.994-1(c)(6)(iii), in turn, defines the costs that are treated as relating to those gross receipts as:

> (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, *determined in a manner consistent with the rules set forth in § 1.861-8.*

26 C.F.R. 1.994-1(c)(6)(iii) (emphasis added). As Congress contemplated, the DISC regulations thus specifically incorporate the cost allocation regulations adopted by the Secretary under Section 861.

In 1977, following public notice and comment, the Secretary adopted final regulations under Section 861 that specifically address cost allocation for DISCs and other purposes. In general, under these regulations, expenses and other deductions are allocated and apportioned to the item or class of gross income to which they are "definitely related." 26 C.F.R. 1.861-8(b)(1). Deductions that are related to all of a taxpayer's gross income, or that are not "definitely related" to any specific class of gross income, are ratably apportioned to all gross income. 26 C.F.R. 1.861-8(b)(5), (c)(1), (c)(2).

In adopting this general cost allocation rule, the Secretary determined that special provision was required for the proper treatment of research expenditures. The regulations note "that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and

development." 26 C.F.R. 1.861-8(e)(3)(i)(A) (1979). In light of these facts, the Secretary determined that research and development expenses are properly to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)." *Ibid.* The regulations adopted in 1977 used the two-digit categories in the Standard Industrial Classification Manual published by the Office of Management and Budget (SIC codes) as the relevant product categories. *Ibid.* When the regulations were revised in 1995, however, the narrower three-digit standard industrial classification codes were adopted as the appropriate product categories for this purpose. 26 C.F.R. 1.861-17(a)(2)(ii). See T.D. 8646, 1996-1 C.B. 145.

3. a. Petitioner elected to group its export sales according to petitioner's internally designated "Airplane Programs" and to use the "combined taxable income" method for determining the transfer price applicable to each grouping. Petitioner therefore computed the "combined taxable income" separately for each program. Pet. App. 2a-3a. In doing so, however, petitioner failed to follow the requirement of the governing regulations that research and development expenses be allocated on the basis of the (then) two-digit industrial classification codes specified in 26 C.F.R. 1.861-8(e)(3)(i)(A). Instead, petitioner allocated the majority of its research and development expenses along narrower, airplane-by-airplane product lines. Pet. App. 3a. The result of the narrower allocation method followed by petitioner was to reduce the research and development expenses allocated to its

export sales, thereby increasing the "combined taxable income" from those sales and decreasing the resulting United States taxes owed by petitioner during the relevant years. *Id.* at 3a-4a.

b. Petitioner's principal business division is its Commercial Airplane Division, which is divided for management and accounting purposes into programs dealing with specific airplane models or with spares, sundry or other activities. Pet. App. 2a. For internal accounting purposes, petitioner divided its research expenditures into two categories: "Blue Sky R&D" and "Company Sponsored Product Development." Of the approximately $4.6 billion in research costs incurred by petitioner during the relevant years, approximately $1.0 billion was classified as "Blue Sky" and $3.6 billion was classified as "Company Sponsored" research. *Id.* at 2a-3a; C.A. E.R. 4-5.

Blue Sky research involved both basic airplane technology and the development of new airplane models prior to the Board's approval of those models as "programs" for production. A large portion of petitioner's Blue Sky research expenses were incurred in "projects" that were the precursors to specific formally identified "programs." For example, during the years involved in this case, petitioner incurred substantial Blue Sky research costs related to what petitioner referred to as the "7X7" project, which eventually became the 767 Program when petitioner's Board of Directors later authorized the production phase of the program. Pet. App. 3a, 17a; C.A. E.R. 62-63, 102.[8]

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[8] The commitment of the Board of Directors to authorize production of a particular airplane model was contingent on petitioner's having received significant firm customer orders for that airplane model. Pet. App. 3a, 17a; C.A. E.R. 105-106, 115-116.

"Company Sponsored" research costs were, by contrast, the research costs that petitioner's accounting system identified with particular airplane programs *after* those programs were approved for production by the Board. The difference between "Blue Sky" and "Company Sponsored" research is thus solely a function of the way petitioner chose to divide its commercial airplane business for internal cost accounting and management purposes. Pet. App. 16a-18a; C.A. E.R. 4.[9]

c. During the years at issue, petitioner had commercial sales of airplanes and services of approximately $64 billion, of which $43 billion (67%) were export sales. C.A. E.R. 2-3, 6, 152. In computing "combined taxable income" for these export sales, petitioner followed the requirements of the governing regulations in part, by allocating its "Blue Sky" research costs among *all* of its airplane programs (although petitioner incorrectly did so on the basis of the number of direct labor hours incurred in each program rather than on the basis of sales). Pet. App. 3a; C.A. E.R. 157. With respect to "Company Sponsored" research, however, petitioner declined to follow the regulations and instead sought to allocate those research costs to the particular programs for which they were ostensibly incurred. Applying that method, petitioner routinely made substantial allocations of "Company Sponsored" research costs to specific airplane programs in years before *any* sales were made by those programs. Of the $3.6 billion classified as "Company Sponsored" research during the years relevant to this case, petitioner allocated

[9] During the tax years at issue in this case, petitioner established or maintained separate management and accounting systems for each of the following airplane models: 707, 727, 737, 737-300, 747, 757 and 767. Pet. App. 16a.

approximately half ($1.75 billion) to programs that had no sales in the year the research was conducted. Although *all* of this $1.75 billion was deducted by petitioner (under 26 U.S.C. 174) in calculating its "taxable income" for the years at issue, petitioner asserts that *none* of that amount should be deducted in determining the "combined taxable income" for the export sales made under the DISC and FSC provisions. Pet. App. 3a; C.A. E.R. 152-153.

d. On audit, the Commissioner determined that petitioner's failure to follow the requirements of the regulation unrealistically inflated the amount of income deferred or exempted under the DISC and FSC provisions. Applying the text of the governing regulation (26 C.F.R. 1.861-8(e)(3) (1979)), the Commissioner allocated all of petitioner's research expenses (both "Blue Sky" and "Company Sponsored") to *all* of petitioner's income from sales of commercial airplanes (since all such airplanes are within the two-digit Standard Industrial Classification Code 37 for transportation equipment) and apportioned those expenses among petitioner's programs on the basis of the sales income in each program. This resulted in a higher allocation of research expenses to petitioner's qualified export sales, a lower "combined taxable income" for those sales under the DISC and FSC provisions, and therefore a greater tax liability for petitioner for each of the years in question. Pet. App. 3a-4a, 18a.

4. Petitioner paid the additional tax and brought this timely suit for refund in the United States District Court for the Western District of Washington. Pet. App. 4a. Petitioner claimed that the regulation adopted by the Secretary to allocate research expenditures in the calculation of "combined taxable income" under 26

C.F.R. 1.861-8(e)(3) is invalid as applied to DISC and FSC transactions.

The district court agreed with petitioner. The court held that there is a "conflict" between the two-digit Standard Industrial Classification Code product categories mandated by 26 C.F.R. 1.861-8(e)(3) and the statement in the DISC regulation that a taxpayer's choice in the grouping of transactions is "controlling" (26 C.F.R. 1.994-1(c)(6)(iv) (1979)). Pet. App. 21a. Adopting the reasoning of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), rev'g 97 T.C. 457 (1991), the district court held that this conflict should be "resolved in Boeing's favor." Pet. App. 21a. Having concluded that the research cost-allocation rule of 26 C.F.R. 1.861-8(e)(3) is invalid for DISC computations, the court awarded a refund of tax and interest to petitioner in the amount of $419,110,539. Pet. App. 4a.[10]

5. a. The court of appeals reversed. Pet. App. 1a-14a. The court emphasized at the outset that Congress has given the Secretary wide latitude to adopt "legislative regulations" to implement these complex statutory provisions. *Id.* at 5a. In view of the considerable deference owed to the Secretary's exercise of these "explicit grants" of rulemaking authority, the court

[10] Because the decision of the district court resulted in a correlative increase in the taxable income of petitioner's FSC, the court also awarded the government a judgment of $481,149 against Boeing Sales Corporation. See *United States* v. *Boeing Sales Corp.*, Cond. Cross Pet. 01-1382 (March 20, 2002) at 3. Petitioners have agreed with the submission of our cross petition that, if the judgment of the court of appeals in favor of the government is reversed in No. 01-1209, the judgment of the court of appeals in favor of Boeing Sales Corporation should be reversed in No. 01-1382 as a purely computational matter. See Pet. Br. 15 n.10.

concluded that the challenged regulations reflect a "permissible interpretation" of the statutes and should therefore be sustained. *Id.* at 5a-6a.

In particular, the court of appeals upheld the Secretary's determination that 26 C.F.R. 1.861-8(e)(3) provides an appropriate method for allocating research expenses in calculating "combined taxable income" under the DISC and FSC provisions. Pet. App. 10a-11a. The court noted that, under the plain text of Section 994(a)(2), "[combined taxable income] is to be calculated based on revenue and costs 'attributable to' sales in the applicable year * * * [and the statute] does not confine the relevant costs to those 'definitely related' to sales of a particular product." *Id.* at 11a. Instead, as the legislative history of the statute makes clear, "Congress recognized some of the costs incurred in a given tax year would not be 'directly related' to specific income items * * * [and] that those costs not 'directly related' would be allocated to export-related sales on a pro rata basis." *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74). The court explained that the challenged regulation "is a permissible interpretation" of the statute and "effectuates this Congressional intent" to ensure that the "total costs" related to export sales—including a pro rata share of research costs—are deducted in calculating the "combined taxable income" from the sale of exported goods. Pet. App. 6a, 11a.

The court of appeals rejected the conclusion of the Eighth Circuit in *St. Jude* that the allocation requirements of 26 C.F.R. 1.861-8(e)(3) are inconsistent with the statement in the DISC regulations (26 C.F.R. 1.994-1(c)(6)(iii)) that expenses "definitely related" to a transaction are to be allocated to that sale. The court emphasized that the DISC regulations cited in *St. Jude* do not define what costs are "definitely related" to a

transaction "other than by reference to § 1.861-8." Pet. App. 9a. And, while the Section 861 regulations themselves contain the same general requirement that costs "definitely related" to a particular product are to be apportioned to that product (26 C.F.R. 1.861-8(b)(2)), these regulations further provide that, in view of the inherently speculative and broad nature of research activities, research costs are to be treated as "definitely related" to "relevant broad product categor[ies]" rather than to particular products. Pet. App. 12a (quoting 26 U.S.C. 1.861-8(e)(3)). No "conflict" could exist between these regulations because the research allocation rule is merely a specific application of the general principles of the regulation in which it is contained, and "[i]t is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 12a (quoting *United States* v. *Borden Co.*, 308 U.S. 188, 198 (1939)).

SUMMARY OF ARGUMENT

I. A. The court of appeals correctly concluded that the regulations adopted by the Secretary to determine the proper allocation of research costs in calculating the "combined taxable income" from export sales represent a "permissible interpretation" of the governing statutes and should therefore be sustained. Congress did not define the term "combined taxable income" in the DISC or FSC statutes. Instead, Congress directed the Secretary to promulgate regulations to determine the "proper" allocation and apportionment of various expenses to items of income (26 U.S.C. 863(a)) and to apply those rules in determining the "combined taxable income" from export sales. Because Congress directed the agency to fill a statutory gap in determining how

expenses are to be "properly allocated" for this purpose, the ensuing legislative regulations are "binding in the courts" unless they are arbitrary or capricious or "manifestly contrary to the statute." *United States* v. *Mead Corp.*, 533 U.S. 218, 227 (2001).

B. The cost allocation regulations adopted by the Secretary generally specify (i) that costs are to be assigned to items of gross income to which they are "definitely related" and (ii) that costs that are related to all of a taxpayer's income, or that are not definitely related to any specific item of income, are to be apportioned ratably to all income. In adopting these regulations, the Secretary determined that special provision was required for the apportionment of research expenses for two separate but related reasons. First, research costs that are currently deducted under Section 174—and are not capitalized and amortized over time—lack a "definite" relationship to any discrete item of income for they are properly attributable to the income of several years, not of a single year. Second, the relationship of research costs to any discrete product is inherently tenuous and difficult to determine, especially when (as in this case) the taxpayer produces more than one product of a related general type. In view of the characteristically broad and speculative nature of research activities, the Secretary reasonably determined in the final regulations that research costs that are currently deducted under Section 174 should be allocated to the "broad product category" to which the research relates and not be allocated simply on the basis of the taxpayer's internal accounting choices. 26 C.F.R. 1.861-8(e)(3)(i)(A).

The use of the 2-digit (and later 3-digit) SIC product codes in defining the relevant "broad product categories" for this purpose was a reasonable choice among

the alternatives. In adopting a regulation that applies for *all* taxpayers, the Secretary appropriately adopted a general standard and was not required to leave this determination to the maze of conflicting management and accounting practices of individual taxpayers.

C. In enacting the FSC provisions in 1984, Congress reviewed the agency's cost allocation regulations and concluded that those rules should continue to apply in "the computation of combined taxable income of a DISC (or FSC) and its related supplier." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1263 (1984). Congress thereby ratified the past application of those regulations and approved their future use. When, as in this case, Congress enacts "a new law incorporating sections of a prior law" and, in doing so, approves the administrative interpretation of those terms, Congress should be understood to have "adopt[ed] that interpretation." *Lorillard* v. *Pons*, 434 U.S. 575, 580-581 (1978).

II. A. Petitioner incorrectly claims that the challenged regulation violates a "fundamental principle" of the governing statutes that costs be allocated based on their "factual relationship" with a product. These statutes contain no such requirement. Instead, they state only that if the Secretary determines that an expense cannot "definitely" be allocated to some item of income, a "ratable part" of that expense is then to be charged to all items of income. 26 U.S.C. 863(a). The challenged regulation, which allocates research costs ratably among the "broad product category" to which the research relates, is consistent with that statutory principle. The regulation falls directly within the broad authority conferred on the Secretary to determine how various expenses are to be "properly apportioned or allocated" to specific items of income. 26 U.S.C. 863(a).

B. The use of the 2-digit SIC code to designate the "broad product group" to which research costs are allocated under the challenged regulation does not, as petitioner asserts, "conflict" with the "grouping" rule of the DISC and FSC regulations. The cost-allocation rules specify the manner in which expenses are allocated in determining "combined taxable income" for DISCs and FSCs. The "grouping" rule has an entirely unrelated function: it allows the taxpayer to select the "groups" of sales that are to be evaluated under the various alternative transfer pricing methods. 26 C.F.R. 1.994-1(c)(7). Whatever "group" of sales is selected by the taxpayer for that purpose, however, the calculation of "combined taxable income" for that group must be made in accordance with the procedures specified in the challenged cost-allocation regulations. The cross-references contained in these two sets of regulations make clear that these coordinated provisions work in tandem and are not "in conflict."

Petitioner's contrary assertion would make the research cost allocation regulation a nullity for the very purpose for which it was adopted. As the court of appeals emphasized, any suggestion that such expressly interrelated regulatory provisions are "in conflict" ignores the "cardinal principle" that, when "there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 12a.

ARGUMENT

I. IN COMPUTING THE "COMBINED TAXABLE INCOME" FROM EXPORT SALES FOR THE PURPOSES OF THE DISC AND FSC PROVISIONS OF THE INTERNAL REVENUE CODE, PETITIONERS MUST TAKE RESEARCH AND DEVELOPMENT EXPENSES INTO ACCOUNT IN THE MANNER REQUIRED BY 26 C.F.R. 1.861-8(e)(3)

In 1977, the Secretary of the Treasury issued regulations to determine how expenditures are to be "properly apportioned or allocated" in computing combined taxable income for purposes of the DISC provisions. 26 U.S.C. 861(b); see 26 U.S.C. 863(a). The regulations adopted by the Secretary generally require that all expenses "definitely related" to the "income" from sales of an exported product, and a pro rata share of expenses "definitely related" to all or no items of "income" of the taxpayer, be allocated to the export sales in determining the "combined taxable income" of the U.S. supplier and its export subsidiary from those sales. 26 C.F.R. 1.861-8(c)(1), (c)(2). The regulations further specify that, in view of the characteristically broad and speculative nature of research activities, costs related to research are to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category [to which the research relates] * * * and therefore allocable to all items of gross income * * * related to such product category * * * ." 26 C.F.R. 1.861-8(e)(3)(i)(A). The court of appeals correctly concluded that these regulations establish a permissible interpretation of the statute and should therefore be sustained.

A. Congress Directed The Secretary Of The Treasury To Issue Regulations To Determine The Manner In Which Expenses Are To Be Taken Into Account In Computing The "Combined Taxable Income" From Export Sales Under The Disc And FSC Provisions Of The Internal Revenue Code

The regulations challenged by petitioners in this case "are legislative regulations because they were promulgated pursuant to [26 U.S.C.] 863(a) and 994(b), which contain explicit grants of authority from Congress." Pet. App. 5a. In enacting the DISC and the FSC provisions, Congress did not attempt to define the statutory construct of "combined taxable income."[11] The history of the DISC provisions, however, reveals that Congress intended that, in implementing this provision, the Treasury would apply "the principles applicable under section 861 for determining" the domestic or foreign source of income. H.R. Rep. No. 533, *supra*, at 74.

Section 861, in turn, has long provided a mechanism for dividing the "source" of income between United States and foreign activities.[12] Under that statute, expenses that are "properly apportioned" to United States source income, and a "ratable part" of expenses that "cannot definitely be allocated" to an item of gross

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[11] The role that the statutory concept of "combined taxable income" plays in determining petitioner's tax liability is set forth in detail at pages 4-5, *supra*.

[12] The geographic "sourcing" of income has been a feature of income tax law since the enactment of Sections 1(a) and 10 of the Revenue Act of 1916, ch. 463, 39 Stat. 756, 765-766, which imposed a tax on income from sources within the United States received by nonresident aliens and foreign corporations. These "sourcing" rules have relevance for several different tax calculation purposes. See note 7, *supra*.

income, are deducted from United States source income in arriving at United States source "taxable income." 26 U.S.C. 861(b). In the 86 years since the first enactment of Section 861, Congress has not attempted to prescribe detailed rules for implementing this provision. Instead, Congress has specified that the determination *whether* an expense *is* "properly apportioned" to an item of gross income is to be made "under regulations prescribed by the Secretary." 26 U.S.C. 863(a).

In enacting these interrelated statutory provisions, Congress thus authorized the Secretary to adopt regulations to determine the "proper" allocation and apportionment of deductions to items of income and to apply those rules in determining the "combined taxable income" from export sales.[13] Because Congress "explicitly left a gap for [the] agency to fill" and made "an express delegation of authority to the agency to elucidate [the] specific provision[s] of the statute by regulation," the "ensuing regulation" adopted by the Secretary to implement that authority is "binding in the courts" unless it is "procedurally defective," "arbitrary or capricious" or "manifestly contrary to the statute." *United States* v. *Mead Corp.*, 533 U.S. at 227 (quoting *Chevron U.S.A. Inc.* v. *Natural Res. Def. Council, Inc.*,

[13] As the court of appeals noted (Pet. App. 5a), in addition to the broad authority conferred on the Secretary of the Treasury to prescribe general regulations for the proper allocation of costs and to use those rules in determining "combined taxable income" for export sales, Congress also authorized the Secretary to "prescribe regulations" for determining the proper "allocation of expenditures in computing combined taxable income" in related contexts involving other distinct types of DISC and FSC transactions. 26 U.S.C. 994(b)(2) (marginal costing rules). See 26 U.S.C. 994(b)(1) (rules for commissions, rentals and other income); see 26 U.S.C. 925(b)(2) (1988) (same under FSC).

467 U.S. 837, 843-844 (1984); see *United States* v. *Morton*, 467 U.S. 822, 834 (1984).

A regulation issued under such an express authority to "prescribe standards" has "legislative effect" (*Batterton* v. *Francis*, 432 U.S. 416, 425 (1977)) and is entitled to the highest degree of deference accorded administrative actions. When Congress has made an "explicit delegation of substantive authority" to the agency, the agency's legislative regulation is entitled "to more than mere deference or weight." *Schweiker* v. *Gray Panthers*, 453 U.S. 34, 44 (1981) (cited in *Chevron*, 467 U.S. at 844 n.12). While the Court has made clear that it "do[es] not abdicate review in these circumstances," it has emphasized that its "task is the limited one of ensuring that the Secretary did not 'excee[d] his statutory authority' and that the regulation is not arbitrary or capricious." *Schweiker* v. *Gray Panthers*, 453 U.S. at 44 (quoting *Batterton* v. *Francis*, 432 U.S. at 426).

As the court of appeals noted (Pet. App. 6a), even if the challenged regulations were regarded as interpretive, rather than legislative, the standard of deference owed to the agency's regulations would remain extremely high. As this Court explained in *United States* v. *Correll*, 389 U.S. 299, 307 (1967):

> Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

B. The Challenged Regulations Establish A Permissible Implementation Of The Governing Statutes And Should Therefore Be Sustained

Recognizing the high degree of deference that applies to both legislative and interpretive regulations under the Internal Revenue Code, the court of appeals correctly concluded that 26 C.F.R. 1.861-8(e)(3) establishes a "permissible interpretation" of the statutes and is therefore valid whether reviewed "under an 'arbitrary or capricious' standard, or under the arguably less deferential 'reasonableness' standard." Pet. App. 5a-6a.

1. *The Basic Framework for Cost Allocation Under 26 C.F.R. 1.861-8 Directly Implements The General Provisions of the Statute*

In 1977, following public notice and comment, the Secretary adopted regulations under Section 861 that specifically address cost allocation in computing "combined taxable income" for DISCs.[14] These regulations are designed "principally to ensure that foreign operations of domestic corporations are charged with a proper share of deductions." B. Bittker & L. Lokken,

[14] The cost-allocation regulations adopted in 1977 state specifically that they govern the allocation and apportionment of research and development deductions in the calculation of "the combined taxable income of the DISC and the related supplier." 26 C.F.R. 1.861-8(f)(1)(iii). Petitioner's assertion that "it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply at all to the computation of CTI" (Pet. Br. 29) is therefore frivolous. Moreover, the DISC regulations *expressly* incorporate the cost-allocation procedures of the challenged regulations in the calculation of "combined taxable income" for the DISC and its supplier. 26 C.F.R. 1.994-1(c)(6). And, following enactment of the FSC provisions in 1984, these same cost-allocation rules were expressly made applicable to FSCs by 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D).

Federal Taxation of Income, Estates and Gifts ¶ 70.10.1, at S70-26 (Supp. 1999). The general provisions of these regulations specify that expenses, losses and other deductions are to be allocated and apportioned to the item or class of gross income to which they are "definitely related." 26 C.F.R. 1.861-8(b)(1), (c)(1). Deductions that are related to all of a taxpayer's gross income, or that are not "definitely related" to any specific item of income, are to be apportioned ratably to all gross income. 26 C.F.R. 1.861-8(b)(5), (c)(2). This general framework of the regulations directly follows the statutory pattern of 26 U.S.C. 861(b) (see pages 19-20, *supra*), and the validity of this general framework is not in question.

2. *Within This Basic Framework, the Secretary Determined That Special Provision Was Required To Ensure That Research Expenses Are Properly Apportioned in Calculating "Combined Taxable Income"*

Congress directed the Secretary to determine, within this general framework, how various expenses are to be "properly apportioned or allocated" to items of income (26 U.S.C. 863(a)), and to apply those rules in calculating "combined taxable income" for DISCs and FSCs. In adopting the cost allocation regulations in 1977, the Secretary concluded that special provision was required for the apportionment of research expenses for two separate, but related reasons.

a. *Research costs that are deducted currently under Section 174 of the Internal Revenue Code are not "definitely related" to specific items of income.* The Internal Revenue Code generally defines "taxable income" as the gross income of the taxpayer less allowable deductions. 26 U.S.C. 63(a). Although tax-

payers may deduct ordinary business expenses in the year they are incurred, "capital" expenses that are related to the production of income in several periods are instead to be "amortized and depreciated" over their useful life. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 83-85 (1992). In this manner, "the Code endeavors to match [capital] expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *Id.* at 84. See also *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 16 (1974).

Research and development expenses are a quintessential example of the type of business expenditures that give rise to income, if ever, in a later year. By their very nature, such expenses are logically to be capitalized and recovered over time as a component of the costs of goods sold. See *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84. In 1954, however, Congress authorized taxpayers to elect to treat research expenses "as expenses which are not chargeable to capital account" and are, instead, "allowed as a deduction" in the year they are incurred. 26 U.S.C. 174(a)(1). When (as in the present case) the taxpayer elects to treat its research expenses as current deductions under Section 174, rather than as capital expenditures, the logical or "factual" link between such costs and the income that they generate is thereby severed. If the taxpayer elects to deduct such expenses immediately—before the results of the research bear fruit in the generation of income—a "direct" or "definite" relationship between the research expense

and the associated future income disappears.[15] As this Court pointed out in *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84, capital costs are "properly attributable" to the income of several years, not of a single year. Because *research costs deducted currently under Section 174 thus lack a "definite" relationship to items of income*, the Secretary *could* have concluded that the deductions resulting from those expenses should, under the general framework of the statute, be "properly apportioned" (26 U.S.C. 863a)) among *all* items of income during the year the deductions are taken.[16] See 26 C.F.R. 1.861-8(c)(2); page 23, *supra*.

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[15] As Amicus Tax Executives emphasizes (Br. 24 n.17), an expense that is "definitely related" to an item of income may be deducted in determining "combined taxable income" whether or not there is any item of income which is received or accrued during the taxable year (26 C.F.R. 1.861-8(b)(2)) and even if "no gross income in such class is received" in that year (26 C.F.R. 1.861-8(d)(1)). Under the regulations, the taxpayer may thus have a negative "combined taxable income" when "there is an excess of deductions" over the income received in that year. 26 C.F.R. 1.861-8(b)(2). In every case, however, the regulations permit expenses allocated in their entirety (rather than pro rata) against an item of income only if the expense "bears a definite relationship to" the item of income. 26 C.F.R. 1.861-8(d)(1). The regulations further specify that, for this purpose, research expenses are treated as "definitely related" to the broad class of products to which the research relates. 26 C.F.R. 1.861-8(e)(3)(i)(A).

[16] When research costs are deducted currently under Section 174, and are not amortized over the period of the product sales, there is no "definite" relationship between those deductions and the income from any associated product or activity. In this case, for example, petitioner attempted to "allocate" $1.75 billion of the research costs that it deducted currently under Section 174 to programs that had no sales in the years the research was conducted. See page 11, *supra*. When ordinary principles of capital cost accounting are not followed, and research costs are not

b. *Research costs inherently benefit a broad class of products for any manufacturer.* The Secretary determined, however, that one additional characteristic of research expenses required further refinement in the treatment of such expenses in the final regulations. The relationship of a research cost to any discrete product is inherently tenuous and difficult to determine, especially when (as in this case) the taxpayer produces more than one product of a related general type. The mere fact that a taxpayer, in its internal accounting, may allocate such costs to a single product obviously does not mean that the research does not in fact benefit the production of other related products of the same type. For example, in this very case, petitioner's officers acknowledged (as common sense suggests) that its research activities are not hermetically sealed and that knowledge and expertise garnered in the development and construction of one airplane model carries over to the production of others. C.A. E.R. 103, 127-128.[17]

In the final regulations, the Secretary determined that, in view of the characteristically broad and specu-

deducted against the income to which those expenses are logically and properly attributable, the "definite" relationship that otherwise generally exists between an expense and the "activity" or "property" to which it is "incident" (26 C.F.R. 1.861-8(b)(2)) is severed. Special provision for allocating research costs that are currently deducted under Section 174 was therefore required within the general framework of the regulations.

[17] Petitioner has also acknowledged that a large portion of its research expenses (denominated as "Blue Sky" research) are properly to be allocated among *all* of its aircraft programs. "Blue Sky" costs differ from the research costs involved in this case primarily in that they were incurred before a specific aircraft model was authorized for production under petitioner's internal accounting and management practices. See page 9, *supra*.

lative nature of research activities, research costs that are deducted currently under Section 174 should not be allocated based on the taxpayer's internal accounting choices but should instead be treated as "definitely related" to the "broad product category" to which the research relates.[18] The final regulations initially specified that the applicable "broad product category" is to be determined by reference to the two-digit SIC codes established by the Office of Management and Budget. 26 C.F.R. 1.861-8(e)(3)(i)(A). After further experience with the regulation, the Secretary refined the relevant "broad product category" for this purpose by reference to the narrower, three-digit SIC codes. 26 C.F.R. 1.861-17(a)(2)(ii) (1996).[19]

The product categories established in the Standard Industrial Classification Manual published by the Office

[18] In determining its "taxable income" for the current period, the taxpayer who elects a current deduction for research costs under Section 174 applies those costs as a deduction against its gross income from *all* sales in the current period. 26 U.S.C. 63(a). The final regulations require that these expenses be treated similarly in determining "combined taxable income" for DISCs and FSCs by providing that research expenses "which a taxpayer deducts under section 174" are to be treated as deductions "definitely related" to income received in the current period. 26 C.F.R. 1.861-8(e)(3)(i)(A).

[19] In adopting the 3-digit SIC code standard in 1996, the Treasury rejected a proposal to employ instead a 5-digit SIC code standard "because such a rule would too narrowly restrict the necessarily broad scope of the deduction." T.D. 8646, 1996-1 C.B. 144, 145. The agency explained that it "continues to believe that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation." *Ibid.*

of Management and Budget provide a rational and administrable standard for this purpose. Utilization of the two-digit SIC Codes ameliorates the effect of a more general treatment of such costs, which could require a taxpayer to allocate its currently deducted research costs among *all* items of current income. See pages 23-25, *supra*. And, although petitioner objects to the breadth of the two-digit SIC code classifications, it is obvious that some administrable rule is required for this purpose. No alternative classification standard or method (other than petitioner's own internal accounting practices) has been suggested by petitioner for this purpose. In adopting a general regulation that applies for *all* taxpayers, the Secretary properly may establish a general standard and is not required to leave this determination to the vagaries of the management and accounting practices of individual taxpayers.[20] As this Court has emphasized, "[i]n view of the Treasury's markedly different goals and responsibilities, * * * any presumptive equivalency between tax and financial accounting would be unacceptable." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542-543 (1979). Accord, *United States* v. *Hughes Props., Inc.*, 476 U.S. 593, 603 (1986); *American Automobile Ass'n* v. *United*

[20] In exercising the responsibility to promulgate regulations that specify how costs are to be "properly apportioned" for this purpose (26 U.S.C. 863(a)), the Secretary has adopted specific regulatory standards to govern the allocation of numerous specific items of expense, such as interest costs, attorneys fees and taxes. 26 C.F.R. 1.861-8(e)(1)-(11). The treatment of research costs under 26 C.F.R. 1.861-8(e)(3) is merely one of the several situations in which a general standard—rather than the individual accounting choices and methodologies of individual taxpayers—controls under the regulations.

States, 367 U.S. 687, 693 (1961) (industry accounting practices are not "binding on the Treasury").

3. *The Secretary's Choice Among Alternative Methods of Apportioning Research Expenses in the Calculation of "Combined Taxable Income" is Reasonable and not Arbitrary or Capricious*

a. The court of appeals correctly concluded that the final rules adopted by the Secretary for the allocation and apportionment of research costs represent a reasonable choice among the alternatives. The regulation reveals on its face that, in determining the items of income to which research costs are to be regarded as "definitely related," the Secretary carefully considered (i) the character of the current deduction allowed for such expenses under Section 174 and (ii) the inherently broad and general relationship of research costs to product development. Based on a detailed consideration of these factors, the Secretary concluded that research expenses "which a taxpayer deducts under Section 174" are to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category" of the taxpayer because research "is an inherently speculative activity" that routinely provides broad benefits for the taxpayer. 26 C.F.R. 1.861-8(e)(3)(i)(A).

That determination by the Secretary falls within the core of his statutory authority to establish regulations for the proper allocation of expenditures in computing "combined taxable income" for DISC and FSC purposes. See page 20 & note 13, *supra*. Even when the Secretary exercises only the general interpretive authority under 26 U.S.C. 7805 to apply the provisions of the Code to the "limitless factual variations" of commerce, this Court has emphasized that "it is the

province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *United States* v. *Correll*, 389 U.S. at 307 (quoting *Commissioner* v. *Stidger*, 386 U.S. 287, 296 (1967)). Deference to the Secretary's detailed judgment in the adoption of such regulations "guarantee[s] that the rules will be written by 'masters of the subject,' *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

b. Contrary to petitioner's assertion (Pet. Br. 39), the research cost allocation regulations adopted by the Secretary do not "penalize exporters who perform R&D on new products by diminishing the tax advantages related to their current exports." Even without the additional tax benefit of approximately $25 million per year that petitioner seeks in this case, Boeing is reported to have been the largest beneficiary of the FSC regime, with a "total FSC tax benefit" of approximately $1.2 billion during the 1990's. J. Oyola, *A Fresh Look at Foreign Sales Corporation Beneficiaries* (Tax Analysts Reference: 2001 WTD 122-15). See also J. Oyola, *Foreign Sales Corporation Beneficiaries: A Profile*, 88 Tax Notes 933, 936 (2000).

The DISC regime was not intended to provide unlimited or "undue tax advantages" to export activities. S. Rep. No. 437, *supra*, at 13. "[T]he question is whether Congress legislated th[e] degree of encouragement" that petitioner seeks. *Archer-Daniels-Midland Co.* v. *United States*, 37 F.3d 321, 323 (7th Cir. 1994), cert. denied, 514 U.S. 1077 (1995). "Obviously it was necessary to control the amount of export income that the parent could defer by use of a DISC." *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995). The function of the "combined taxable income" determination made under the regulations "is to fix a 'transfer price' between the parent and the DISC which, in turn, limits the amount of income of which the parent can defer realization." *Ibid.*

If the Secretary had adopted the rule that petitioner proposes, and had allowed research costs to be attributed to specific products without regard to a "definite" relationship to the income from such products, the most basic objectives of the statute and regulations would have been defeated. Under petitioner's theory, research costs *routinely* would be ignored in the calculation of "combined taxable income." This is because the bulk of research costs are commonly incurred in years *before* production and sales occur. See note 16, *supra*. By failing to apportion research costs to income to which they are "definitely" related, petitioner's proposed allocation method would vastly overstate the "combined taxable income" from export sales by violating the fundamental requirement that "the *total costs* of the DISC and related supplier *which relate to such gross receipts*" be deducted in computing "combined taxable income." 26 C.F.R. 1.994-1(c)(6) (emphasis added).[21]

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[21] For example, in the present case alone, petitioner's alternative method of calculating "combined taxable income" overstates the actual net income resulting from its sales by approximately $1.75 billion. That is the amount of research costs that petitioner seeks to (i) charge to specific programs in years when no sales in those programs occurred and (ii) thereafter ignore in the later periods when sales occurred and income was in fact received. See note 16, *supra*.

C. In Enacting The FSC Provisions In 1984, Congress Ratified Application Of The Challenged Research Cost Allocation Regulations To Discs And Expressly Authorized Application Of Those Regulations To FSCs

By the time that Congress enacted the FSC provisions in 1984, the regulations that allocate research expenses in "combined taxable income" calculations (26 C.F.R. 1.861-8(e)(3)) had been in place for seven years. In enacting the FSC provisions, which borrowed heavily from the DISC provisions, Congress stated that it "intends that rules comparable to the rules in regulations issued under th[e DISC] provisions will be appli[cable] to the FSC." 1 Staff of the Senate Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984*, at 636 (Comm. Print 1984). The DISC regulations to which Congress referred expressly incorporate the cost allocation rules of 26 C.F.R. 1.861-8(e)(3). See 26 C.F.R. 1.994-1(c)(6)(iii). The reference in the legislative history of the FSC provisions to the existing DISC regulations demonstrates that Congress intended the cost-allocation rules established in those prior regulations to apply under the FSC provisions as well.

This conclusion was made manifest in another portion of the FSC legislative history. As part of the legislation that enacted the FSC, Congress specifically addressed and extended a moratorium that had been imposed in 1981 on the application of the Section 861 cost allocation regulations for the limited purpose of determining whether income has a United States or foreign source.[22]

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[22] Due to concerns relating to the sourcing of income in making foreign tax credit calculations, Congress imposed a temporary moratorium on the application of the cost allocation rules of 26 C.F.R. 1.861-8(e)(3) solely for the *sourcing* of income. See Section 223 of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 249; Section 126 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 648; Section 13211 of the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 324. That moratorium was lifted in 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1216, 100 Stat. 2549.

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 126, 98 Stat. 648. In doing so, Congress specified that the moratorium on *that* use of the cost-allocation regulations "*does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier.*" H.R. Conf. Rep. No. 861, *supra*, at 1263 (emphasis added). See *Intel Corp.* v. *Commissioner*, 76 F.3d at 983 (holding that the moratorium does not apply to the computation of DISC "combined taxable income"); *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d at 1403-1405 (same).

In enacting the FSC provisions, Congress thus expressed the clear understanding and intention that the cost-allocation rules of 26 C.F.R. 1.861-8(e)(3) *are* controlling in the calculation of "combined taxable income" not only for DISCs but also for FSCs. Congress thereby ratified the past application of those regulations and approved their future use.

As this Court has frequently observed, when Congress enacts "a new law incorporating sections of a prior law" and, in doing so, approves the administrative interpretation of those terms, Congress should be understood to have "adopt[ed] that interpretation." *Lorillard* v. *Pons*, 434 U.S. 575, 580-581 (1978). See *Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 414 n.8 (1975) (Congress has thereby "ratified this construction"). In particular, this Court has "held in many

cases" that a "long-standing administrative interpretation" set forth in a Treasury regulation that interprets the predecessor of "a substantially reenacted statute, is deemed to have received congressional approval and has the effect of law." *Commissioner* v. *Estate of Noel*, 380 U.S. 678, 682 (1965) (citing cases). See also *Heard* v. *Commissioner*, 326 F.2d 962, 966 (8th Cir.), cert. denied, 377 U.S. 978 (1964); N. Singer, *Sutherland Statutory Construction* § 22:33, at 399 & n.11 (6th ed. 2002).[23]

II. THE CHALLENGED RESEARCH COST-ALLOCATION RULES DO NOT CONFLICT WITH ANY PROVISION OF THE DISC AND FSC STATUTES OR REGULATIONS

Petitioner argues that the Secretary's treatment of research costs under the regulations is invalid for two reasons. First, petitioner asserts that the regulations violate a "rule * * * established by the plain language of the DISC statute" that "costs that are factually

[23] Petitioner suggests that the FSC provisions need not be addressed in this case because the parties "agreed that there are no differences between DISC and FSC that are relevant to this case" (Pet. Br. 3 n.2). Although the parties agreed that "differences between the DISC and FSC rules" are not material to this case (Stip. ¶ 28), the parties have *not* agreed that the history of the enactment of the FSC is irrelevant. To the contrary, the government pointed out in the court of appeals that this history reflects an express approval by Congress of the regulation involved in this case and, indeed, that "it is difficult to make a stronger case for the application of the legislative reenactment doctrine." Gov't C.A. Br. 40. See Gov't C.A. Reply Br. 24. Petitioners also addressed the reenactment doctrine in their brief in the court of appeals. Pet. C.A. Br. 55-59. The court found it unnecessary to reach the issue, however, because it upheld the regulation on the merits as a permissible interpretation of the statute. See Pet. App. 5a-6a.

related to one product (or product group) may not be deducted from revenue arising from the sale of a different product (or product group)." Pet. Br. 15. Second, petitioner claims that the requirement of the regulations that research costs be allocated to the broad product group to which those costs relate violates the "grouping" rules of the DISC and FSC regulations that allow the taxpayer to group its export sales within narrower product categories in applying the transfer price rules of those statutes. Pet. Br. 16-17. Neither of these objections to the challenged regulations is valid.

A. The Research Cost Allocation Regulations Properly Implement, And Do Not Conflict With, The Governing Statutes

1. *The Challenged Regulations Properly Implement the Governing Statutes*

Petitioner errs in claiming (Pet. 15) that it is a "fundamental principle" of the governing statutes that costs are to be allocated based on their "factual relationship" with a "product" or "product group." The applicable statutes do not contain any such requirement.[24]

[24] Amicus Tax Executives Institute errs in suggesting (Br. 25) that any ambiguity in the statutes that govern this case should be construed against the government. In *White* v. *United States*, 305 U.S. 281, 292 (1938), this Court expressly rejected the proposition that "doubts should be resolved in favor of the taxpayer." The Court has instead long applied "the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84 (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)). This rule applies with special force to the DISC and FSC, for "[i]t has been said many times that provisions granting

a. Section 863(a) directs the Secretary to determine, by regulations, which expenses are to be "properly apportioned and allocated" to specific items of "income." 26 U.S.C. 863(a). This statute does not state whether a "factual relationship" or a "logical relationship" or some other type of "relationship" is sufficient. The statute states only that, if the Secretary determines that an expense "cannot definitely be allocated to some item * * * of gross income," then a "ratable part" of that expense is to be charged to all items of income. *Ibid.* As we have explained above, the challenged regulation is based on, and conforms with, these broad statutory principles. See pages 19-29, *supra*.

b. The DISC and the FSC statutes and their legislative histories also do not define how the Secretary is to determine which costs are, or are not, "definitely related" to items of income. The "statutory text does not confine the relevant costs to those 'definitely related' to sales of a particular product." Pet. App. 11a. As the Tax Court stated in upholding the challenged regulations, "[a] requirement that an expense be 'definitely related' to gross income from export receipts in order to be allocated to the item does not exist in the text of sections 994(a) or (b) or 861(b) [or 925(a)]." *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. at 478.

c. The phrase that is the centerpiece of petitioner's argument appears only in the Secretary's regulations, and not in the statutes. It is the DISC and FSC regulations—and not the statutes—that specify that "costs that are 'definitely related' to gross receipts from the sales of export property and costs that are 'not

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special tax exemptions are to be strictly construed." *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46, 49 (1940) (citing cases).

definitely related' to a class of gross income * * * are treated as costs 'relating' to gross receipts from sales of export property and therefore enter into the combined taxable income computation." *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. at 478 (citing 26 C.F.R. 1.994-1(c)(6)(iii)); see also 26 C.F.R. 1.861-8(c)(1), (c)(2)).

The portion of the regulation challenged in this case —which defines research expenses currently deducted under Section 174 to be "definitely related" to income generated by a broad class of similar products—is simply an elaboration by the Secretary of the general standard established in the agency's own regulations. As we describe above (pages 23-29, *supra*), this fact-specific elaboration of this *regulatory* standard falls directly within the broad authority of the Secretary to "promulgate regulations" to determine how various expenses are to be "properly apportioned or allocated" to specific items of income. 26 U.S.C. 863(a).

2. *The "Principles Applicable Under Section 861" do not Require a "Factual Relationship" Between Income and Expense in Allocating and Apportioning Current Expense to Current Income*

a. Ignoring the text of the governing statutes, petitioner nonetheless argues that the "fundamental principles" of these statutes require that expenses be assigned only to products to which they are "factually related." The "factually related" standard on which petitioner rests its argument, however, appears only in the portion of the Treasury's regulations that describes, in general terms, how expenses are allocated *under the regulations*. After setting forth the general rule of the regulations that expenses are allocated to the income to which they are "definitely related" (26 C.F.R. 1.861-8(a)(2)), the sentence of the regulation on which peti-

tioner relies states that, "*[a]s further detailed below*, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income." 26 C.F.R. 1.861-8(a)(2) (emphasis added). Of course, it was in adopting these very regulations that the Secretary clearly specified in the provisions "further detailed below" that a sufficient factual and logical relationship exists for this purpose between research expenses currently deducted under Section 174 and the income earned during that period from sales of products within the related broad product groups. 26 C.F.R. 1.861-8(e)(3)(i)(A). The *full* text of the regulation thus refutes petitioner's reliance on the small portion of the regulation that it chose to quote.

b. Petitioner asserts (Pet. 24-26) that the Secretary should not be permitted to adopt the research cost allocation rule of the final regulation because the 1973 proposed regulations contained no such provision. Petitioner is unquestionably wrong, however, in suggesting that the Secretary is bound by each and every phrase in a proposed regulation. A proposed regulation is nothing more than a "suggestion[] made for comment." *LeCroy Research Systems Corp.* v. *Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984). "If the Commissioner wanted [the proposed] regulation to have binding effect, it could have been issued as a temporary regulation." *Ibid.* Furthermore, in adopting the *final* regulations, the Secretary plainly was not required to give each phrase of the proposed regulations the meaning that petitioner now seeks.[25]

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[25] For example, while petitioner makes much of the supposed need for a "factual relationship" between income and expenses—a phrase that is nowhere to be found in the governing statutes—it studiously avoids explaining why aircraft research is not "factually related" to the income from aircraft sales.

In claiming that the 1973 proposed regulation should govern this case, petitioner errs in relying on a selected portion of the Technical Memorandum that accompanied the proposed DISC regulations (Pet. Br. 23). In quoting that Memorandum, petitioner has omitted the sentences that underscore that the regulations had *not* been cast in concrete at the time they were first proposed. The omitted sentences state (1972 T.M. Lexis 14, at *8-*9 (June 29, 1972) (emphasis added)):

> In determining deductible expenses attributable to the property and transaction, the rules of section 861(b) and 1.861-8 are to be applied *in whatever form they ultimately take in a new notice to be prepared. * * * It is anticipated that rules will be later developed under 1.861-8 or the Treasury decision containing 1.994-1 to allocate expenses incurred in one year to items of gross income received in another year.*

This Technical Memorandum reflects the agency's understanding, at the time that the proposed regulations were issued, that timing problems in the apportionment of costs incurred in one year to revenues earned in other periods needed to be further addressed in the final rules.

The challenged research cost allocation rules ultimately adopted in the final regulations, of course, respond directly to this timing concern. See pages 23-29, *supra*. And, prior to the final adoption of these regulations in 1977, the research cost-allocation rules were issued as *amended* proposed rules for public comment in 1976. 41 Fed. Reg. 49,160 (1976).

Petitioner incorrectly suggests (Pet. Br. 24) that the provisions of the 1973 *proposed* regulations, rather than the provisions of the 1977 *final* regulations, should be understood as the cost allocation "rules set forth in §1.861-8" (26 C.F.R. 1.861-8(c)(6)(iii)) that were incorporated by the DISC regulations in 1975. In issuing the DISC regulations in 1975, the agency clearly stated that the 1973 "proposed regulations" under Section 861 had relevance only "for informational purposes." T.D. 7364, 1975-2 C.B. 315, 316. The agency also made clear that a cross reference in the DISC regulations to other regulations that were, at that time, only proposed is "intended to refer to such regulations as will be finally adopted." *Ibid.*

c. Petitioner also errs in claiming (Pet. Br. 19) that the Secretary may not allocate deductions "partly to the particular sale in question and partly to completely unrelated sales." The text of the governing statute clearly provides that "a ratable part of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*" shall be deducted in arriving at taxable income. 26 U.S.C. 861(b) (emphasis added). As the Ninth Circuit (Pet. App. 11a) and the Tax Court in *St. Jude* (97 T.C. at 478) have correctly recognized, the governing statutes and regulations explicitly require that a ratable part of expenses that are *not* definitely related to any specific item of income are to be charged against *all* items of income.

Even though research expenses deducted currently under Section 174 are not "definitely" or "directly" related to the "income" earned from specific products in *any* specific period (see pages 23-25, *supra*), petitioner suggests that the mere existence of *some* relationship between its research and *future* income should suffice.

If petitioner had capitalized its research costs, the annual amortization of such costs would then have had a logical or "factual" relationship to its future income and could then be said to be "properly attributable" to that income as it is earned. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84. But when, as in this case, the taxpayer elects currently to deduct its research costs (as Section 174 allows), the taxpayer thereby destroys any "definite" or "factual" relationship between those expenses and the income earned. See note 16, *supra*.

The improper treatment of research costs that petitioner advocates in this case would vastly overstate the benefits to which petitioner is entitled under the DISC and the FSC regimes. Petitioner seeks to exclude approximately $1.75 billion in research expense deductions in calculating its "combined taxable income" even though those expenses were in fact deducted in determining its "taxable income" under the general provisions of the Code. See note 16, *supra*. Through this inconsistent treatment, petitioner seeks to treat a substantial portion of its aggregate taxable income as if it were export-related, when in fact it is not.

B. The Research Cost Allocation Rules In 26 C.F.R. 1.861-8(e)(3) Do Not Conflict With The "Grouping" Rules In The DISC And FSC Regulations

1. Under the DISC and FSC provisions, the taxpayer has three options for calculating the "transfer price" that is used in determining the amount of income that is deferred under DISC or exempted under FSC. 26 U.S.C. 994(a); 26 U.S.C. 925(a). Only one of these options requires a calculation of the "combined taxable income" of the taxpayer and its sales subsidiary. The others are based on a percentage of export sales

revenues or on an assumed "arms length price" for the transfer. See page 5, *supra*.

In the ordinary case, the "transfer price" is to be determined on a transaction-by-transaction basis for each individual "sale of export property." 26 U.S.C. 944(a); 26 U.S.C. 925(a). The DISC and FSC regulations, however, allow a taxpayer to elect to apply the "transfer price" rules on the basis of "groups" of exported products or product lines. Different "grouping" regulations were adopted for this purpose under the DISC and FSC regimes. 26 C.F.R. 1.994-(c)(7)(i) (DISC); 26 C.F.R. 1.925(a)-1T(c)(8) (FSC). These "grouping" rules are administratively efficient, for they make it unnecessary for the taxpayer to file a separate transfer price schedule for each and every sale. The "grouping" rules also provide flexibility, for they permit a taxpayer to elect one of the three "transfer price" rules for one group of products and a different "transfer price" option for another group.

The regulations generally give taxpayers a wide discretion in determining which group of products to select for separate transfer price determinations. The regulations specify that the taxpayer's choice to group a "product or product line will be accepted" if it conforms either to "a recognized industry or trade usage" or the "two-digit major groups * * * of the [SIC codes]." 26 C.F.R. 1.994-1(c)(7). The DISC regulations further state that a grouping choice made by the taxpayer "in accordance with" these criteria will be "controlling." 26 C.F.R. 1.994-1(c)(6)(iv).[26]

2. Petitioner claims (Pet. Br. 30) that the statement in these regulations that the taxpayer may "group" its

[26] The FSC regulations do not contain a similar statement. See 26 C.F.R. 1.925(a)-1T(c)(8).

sales for transfer price determinations by reference to "recognized industry or trade usage" (26 C.F.R. 1.994-1(c)(7)) conflicts with the requirement in the cost-allocation regulation that, in calculating "combined taxable income," research costs are to be allocated among all related products within the two-digit SIC code (26 C.F.R. 1.861-8(e)(3)(i)(A)). As the Tax Court explained in rejecting this assertion in the *St. Jude* case, however, "[t]he grouping provisions do not supersede the * * * allocation and apportionment provisions because the provisions are not in conflict." 97 T.C. at 480.

a. The cost-allocation regulations specify the manner in which expenses and other deductions are allocated and apportioned in determining "combined taxable income" for DISCs and FSCs. 26 C.F.R. 1.861-8(f)(1)(iii). It is, of course, for this very reason that the cost-allocation rules of 26 C.F.R. 1.861-8 are expressly cited and specifically incorporated in the DISC and FSC regulations. 26 C.F.R. 1.994-1(c)(6)(iii); 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D). A calculation of "combined taxable income" has relevance, however, only if the taxpayer elects that option from among the three available choices for determining the "transfer price" for the transactions.

b. The "grouping" rules of 26 C.F.R. 1.994-1(c)(7) have an entirely different and separate function. The grouping rules do not purport to prescribe rules for allocating or apportioning expenses. They instead merely allow the taxpayer to elect *which groups of sales* will be evaluated under one, or another, of the three alternative transfer pricing methods. See 26 C.F.R. 1.994-1(a)(1). As the Tax Court explained in *St. Jude* (97 T.C. at 480):

The grouping provisions permit taxpayers to group transactions for purposes of applying the three DISC transfer pricing methods allowed by section 994(a). That is, a taxpayer may use the 4-percent gross receipts method, the 50-50 combined taxable income method, or the [arm's length pricing] method for different product-line groups during the same year. However, regardless of the product-line groups a taxpayer uses, and whether based on recognized industry trade usage or otherwise, if the taxpayer uses the 50-50 combined taxable income method, research and development expenses are allocable and apportionable, with respect to export receipts attributable to that product-line group, consistent with [the cost-allocation requirements of 26 C.F.R. 1.861-8].

In view of the coordination intended between (and specified within) the provisions of these related regulations, it makes no sense to assert that there is a fatal "conflict" in their application. The research expense allocation requirements of the Section 861 regulations *expressly* state that *they* apply in determining "combined taxable income" for DISC and FSC purposes. 26 C.F.R. 1.861-8(f)(1)(iii), (8)(g) (Examples 22-23). The DISC and FSC regulations *also* expressly state that cost allocations for DISC and FSC purposes "are to be determined in a manner consistent with the rules set forth in [the Section 861 regulations]." 26 C.F.R. 1.994-1(c)(6)(iii).[27]

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[27] In *St. Jude*, the Eighth Circuit reversed the Tax Court and accepted petitioner's assertion that these two regulations are in "conflict." 34 F.3d at 1402. In doing so, however, the court of appeals did not address or respond to the Tax Court's explanation of the separate and limited purpose served by the "grouping" regulations. The court instead simply assumed (as petitioner does in its brief here) that, once an election is made under the "grouping" regulations, "costs should be allocated and apportioned accordingly." *Id.* at 1401. As we describe in the text, however, the plain text of the regulations refutes that assumption.

c. In arguing that these regulations should be viewed as in "conflict," petitioner ignores not only their plain text but also the applicable legal principles. Under petitioner's theory that the research expense allocation rules are inapplicable for the determination of "combined taxable income" for exported products, the allocation rule would be made a nullity for the *express* purpose for which it was adopted. See 26 C.F.R. 1.861-8(f)(1)(iii). As the court of appeals emphasized in this case, petitioner's suggestion that such interrelated regulatory provisions are "in conflict" ignores the "cardinal principle of construction that . . . [w]hen there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 9a (quoting *United States* v. *Borden Co.*, 308 U.S. at 198).

Similarly, petitioner's assertion that a "conflict" exists between these regulations ignores the settled rule that the agency's interpretation of its own regulations is "entitled to controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965) (quoting *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-414 (1945)). The Secretary's consistent and reasoned explanation of the way in which these provisions cooperate, rather than "conflict," is entitled to special weight in this case because, in enacting the FSC, Congress ratified application of the challenged regulations for "the computation of combined taxable income of a DISC

(or FSC) and its related supplier." H.R. Rep. No. 861, *supra*, at 1333. See page 33, *supra*.

CONCLUSION

The judgment of the court of appeals should be affirmed.[28]

Respectfully submitted.

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[28] For the reasons acknowledged by petitioners (Pet. Br. 15 n.10), if the portion of the judgment of the court of appeals in favor of the government is reversed, the portion of the judgment of the court of appeals in favor of cross-respondent should then also be reversed.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations set forth in the appendix to the petition, the following statutes and regulations are involved in this case.

1. Section 174 of the Internal Revenue Code, 26 U.S.C. 174, provides in relevant part:

(a) Treatment as Expenses.—

(1) In general.—

A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

* * * * *

(b) Amortization of Certain Research and Experimental Expenditures.—

(1) In general.—

At the election of the taxpayer, * * * research or experimental expenditures * * * may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer * * *.

* * * * *

2. During the years relevant to this case, 26 U.S.C. 925 (1985) (added by Pub. L. No. 98-369, Div. A, Tit.

VIII, § 801(a), 98 Stat. 990) (July 18, 1984), provided, in relevant part:

(a) In general.—

In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,

(2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

(b) Rules for commissions, rentals, and marginal costing.—

The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

(c) Requirements for use of administrative pricing rules.—

A sale by a FSC meets the requirements of this subsection if—

(1) all of the activities described in section 924(e) attributable to such sale, and

(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale, have been performed by such FSC (or by another person acting under a contract with such FSC).

(d) Limitation on gross receipts pricing rule.—

The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the amount which would be determined under subsection (a)(2) with respect to such transaction.

(e) Taxable income.—

For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

(f) Special rule for cooperatives.—

In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall

not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

2. 26 C.F.R. 1.925(a)-1T (1989) provided, in relevant part:

Temporary Regulations; Transfer pricing rules for FSCs

* * * * *

(c)(6) *Full costing combined taxable income*—(i) *In general.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of § 1.482-2(b)(1) through (6). Section 1.482-2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (i.e., the related supplier) or the member receiving the benefit of the services (i.e., the FSC), shall not apply if the administrative pricing methods of section 925(a) (1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482-2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See § 1.925(a)-1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs.* In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii) (A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii) (B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in

§ 1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) Cooperatives and combined taxable income method. If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382(b) and (c) for patronage dividends, per-unit retain allocations and nonpatronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) [Reserved]. For further guidance, see § 1.925(a)-1(c)(8)(i).

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and § 1.923-1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923 (a)(4) increases the amount of the FSC's exempt

foreign trade income with regard to sales of these products, see § 1.923-1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see § 1.924(d)-1(e)).

* * * * *

(g) Effective date. The provisions of this section and § 1.925 (b)-1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

3. Since December 22, 1995, 26 C.F.R. 1.861-17 has provided (T.D. 8646, 60 Fed. Reg. 66,503 (1995)):

§ 1.861-17 Allocation and apportionment of research and experimental expenditures.

(a) Allocation—(1) In general. The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) Product categories—(i) Allocation based on product categories. Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) Use of three digit standard industrial classification codes. A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) Consistency. Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit

SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

* * * * *

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In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR THE PETITIONERS

The government's brief contains a number of remarkable omissions and misstatements. The government never responds *at all* to any of our principal arguments. It virtually ignores the text of the controlling statute. It disregards almost all of the relevant legislative history. It does not even mention crucial regulatory provisions. It misstates the regulatory background. And it makes no attempt to defend the reasoning of the Ninth Circuit.

These omissions and misstatements are central to the government's position. At the end of the day, the government really makes only one argument: that the Court should defer to the government's application of Treas. Reg. § 1.861-8(e)(3) because the DISC statute says nothing about how costs should be assigned to revenues. But this talismanic invocation of deference is manifestly insufficient to carry the day. In fact, the DISC statutory and regulatory regime makes unmistakably clear that product-specific costs must bear a factual relationship to the revenues from which they are deducted; that taxpayers are entitled to choose the method by which they group revenues and expenses; and that such grouping "will be accepted" and "shall be controlling" for purposes of determining CTI. Deference to an agency is inappropriate where, as here, the administrative position is flatly inconsistent with the plain terms of the controlling statute, with other indicia of congressional intent, and with the regulations interpreting that statute. The government's contention therefore should be rejected and the decision of the Ninth Circuit reversed.

A. Costs That Are Directly Related To Particular Income Must Be Allocated Exclusively To That Income

1. In our opening brief, we showed that, when calculating CTI on the basis of product groups that are recognized by industry usage, costs that are directly and factually related to a particular product group must be allocated exclusively to *that* group; they may not be allocated to other product groups to which they are *not* related. The government's response insists that is not so, maintaining that "[t]he applicable statutes do not contair any such [factual relationship] requirement." U.S. Br. 35. This assertion, however, ignores *all* available evidence of Congress's intent.

First, we explained in our opening brief that the factual relationship requirement is established by the DISC statute, which provides that a DISC's CTI is the income "attributable to" an export sale. IRC § 994(a)(2). As this Court has held elsewhere in the federal tax context, "attributable to" means "caused or generated by." *Braunstein* v. *Comm'r*, 374 U.S. 65, 70 (1963). Income "attributable to" a sale therefore necessarily consists of gross revenues from the sale less the factually related expenses that generated the sale. Pet. Br. 18-20. The government nowhere acknowledges the import of this controlling DISC statutory language; *it makes no response at all to our argument on this critical point.*

Second, we explained in our opening brief that Congress intended CTI to "be determined generally in accordance with the principles applicable under [IRC] section 861[.]" H.R. REP. NO. 92-533, at 74 (1971); S. REP. NO. 92-437, at 109 (1971). We noted that Congress enacted the DISC legislation against the background of IRC § 861(b), a statute that had been in effect without substantive change for 50 years and that establishes how deductible costs are assigned to items or classes of gross income when determining the geographical

source of income. In particular, § 861(b) provides that, in calculating net income for this purpose, taxpayers must deduct from a particular item or class of gross income expenses that are "properly apportioned or allocated" to that item or class, as well as a ratable portion of "deductions *which cannot definitely be allocated to some item or class of gross income.*" This formula plainly means that if an expense *can* be allocated to a certain item or class of income, it may *not* be ratably apportioned across all items or classes of income. See Pet. Br. 20-21. We also explained that the regulations interpreting § 861 that the Treasury Department proposed in 1966 – which Congress would have had before it when it enacted the DISC statute five years later – expressly confirmed that deductions definitely related "to a single item or class of gross income *shall be allocated thereto.*" See Pet. Br. 21. Again, the government makes no attempt to address the relevant statutory language, does not acknowledge the proposed regulatory language at all, and *makes no response to our contention on the point.*

Third, we explained in our opening brief that the congressional tax-writing committees declared in unambiguous terms *how* Congress wanted the § 861 allocation and apportionment principles to apply in the computation of DISC income. As both committees put it, CTI is to be calculated by deducting from the DISC's gross receipts those expenses "which are *directly related* to the production or sale of the export property and *a portion* of the * * * expenses not allocable to *any* specific item of income." See Pet. Br. 21-22. Under this formulation, it plainly is improper to require taxpayers to take expenses that *are* directly related to the sale of *particular* property and apportion them to income from the sale of *unrelated* property. Again, although the government cites other portions of the committee reports, it does not quote or acknowledge the crucial report language and *makes no response to our argument on this point.*

Fourth, we explained in our opening brief that the Treasury Department's contemporaneous understanding of the DISC statute, dating back to 1972, recognized expressly that expenses directly related to a particular class of income *must* be allocated to that income in calculating CTI, and that only expenses not definitely related to *any* class of income may be ratably apportioned across income classes. See Pet. Br. 23-24. We also noted that, when the final DISC regulation (with its cross-reference to Treas. Reg. § 1.861-8) was issued in 1975, the proposed § 861 regulation then pending (which was published in 1973) also unambiguously applied the factual relationship principle to R&D in the DISC context. See Pet. Br. 24-26. This contemporaneous agency understanding has particular force in determining the meaning of the controlling DISC statute. See *id.* at 23. Yet again, the government *makes no response to our argument on this point.*

Instead, the government spends considerable space addressing an argument that we do not make. The government maintains that the Secretary is not "bound by each and every phrase in a proposed regulation" and that "the 1973 *proposed* [§ 861] regulations" do not govern here. U.S. Br. 38, 40 (emphasis in original). Our point, however, is not that the 1973 proposed version of Treas. Reg. § 1.861-8 has the force of law; it is, rather, that *the Treasury Department's own best understanding of the DISC statute, at the time closest to enactment of the legislation* (when the Secretary drafted the proposed § 861 regulations and issued the final DISC regulations), was that the law precluded the allocation of expenses to a particular class of income when those expenses were definitely and factually related to a different class of income. *The government does not address this point.*[1]

[1] The government appears to suggest that, when the final DISC regulations were issued in 1975, the Treasury Department anticipated that the proposed § 861 regulations would change. Quoting the preamble to the DISC regulations, the government asserts that "[i]n issuing the DISC regulations in 1975, the agency clearly stated that * * * a cross reference in the DISC regulations to other regulations that were, at the time, only proposed is 'intended to refer to such regulations as will be finally adopted.'" U.S. Br. 40 (quoting T.D. 7364, 1975-2 C.B. 315, 316). This misrepresents the preamble, which refers to proposed regulations under *both* sections 993 and 861 but singles out *only* the cross-reference to proposed regulations "under section 993" as being "intended to refer to such regulations as will be finally adopted." T.D. 7364, at 316 (emphasis added). This statement does not extend to the proposed regulations under § 861.

The government's utter failure to offer any response to our arguments regarding the meaning of the DISC legislation is enough to dispose of this case. For the reasons set out in our opening brief and noted above, there can be no doubt that, in calculating CTI based on recognized product groupings, the DISC statute precludes the assignment of costs that are specifically associated with *one* product grouping to income generated from the sale of products from *another* grouping. Yet it is undisputed that the government's application of Treas. Reg. § 1.861-8(e)(3) in this context would have precisely that effect: the government does not deny that (for example) its approach would *require* that R&D costs for the development of an improved cotton ball be deducted from income generated through the sale of space suits. The DISC statute does not allow such a result.

2. Perhaps because it is unable to account for the terms of and intent behind the DISC statute, the government tries to approach its problem from another direction: it makes the astounding assertion that R&D *inherently* lacks a factual connection to income from the sale of particular products. This is so, the government argues, because R&D expendi-

tures invariably "give rise to income, if ever, in a later year," so that "[w]hen (as in the present case) the taxpayer elects to treat its research expenses as current deductions under [IRC] Section 174, rather than as capital expenditures, the logical or 'factual' link between such costs and the income that they generate is thereby severed [and] a 'direct' or 'definite' relationship between the research expense and the associated future income disappears." U.S. Br. 24-25. This contention is wrong on several levels.[2]

a. To begin with, the government's "severance of a definite relationship" argument – which was not made below – is wholly illogical. The fact that R&D expenses give rise to "future income" can hardly justify treating them differently from all other expenses, because virtually *every* expense gives rise to "future income." Expenses that generate income at the moment they are incurred are rare indeed. If R&D expenses differ at all from other expenses in this respect, it is only because the "future," in the case of income generated by an R&D expense, tends more often to be a later *tax period* than is the case of income generated by many other expenses.[3]

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[2] In deciding how seriously to take the government's argument, we note that the rationale advanced in the government's brief apparently has been devised solely for use in this litigation; it was not the actual premise for the regulation. The real justification for the R&D rule, which is stated in the regulation itself, is *not* that it is difficult to determine the relationship of research to particular income, but rather that research is "inherently speculative," that research findings may "contribute unexpected benefits," and "that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation." Treas. Reg. § 1.861-8(e)(3)(i)(A). The government makes no attempt to assert *that* rationale here.

[3] That is not invariably so, however. Many types of currently deductible non-R&D expenses – for example, expenses related to the development and implementation of an advertising campaign – give rise to income in future tax periods. See Treas. Reg. § 1.162-20(a)(2) (allowing the current deduction of expenditures for institutional or "good will" advertising "related to the patronage the taxpayer might reasonably expect in the future").

But the government never explains, and cannot plausibly explain, how the "'factual' link between [R&D] costs and the income they generate is severed" by the tax code's arbitrary division of time into annual tax periods.[4]

Indeed, the government's argument on this point is little more than an attempt to repackage the unpersuasive "disappearing R&D" contention that it advanced below and that we address in our opening brief at 37-39. But however it is formulated, the government's contention is squarely contradicted by its own regulations. Treas. Reg. § 1.861-8(b)(1) unambiguously states that expenses must be allocated to the class of gross income to which the expenses are definitely related "without regard to the taxable year in which such gross income is received or accrued or is expected to be received or accrued." And Treas. Reg. § 1.861-8(d)(1) explicitly recognizes that the separation of a deduction and the income it generates into different tax periods does *not* sever the "definite relationship" of the deduction to the income.

Actually, there is reason to doubt that the government believes its own theory. Elsewhere in its brief, the government acknowledges that, "[i]f petitioner had capitalized its research costs, the annual amortization of such costs would

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[4] In fact, whether taxpayers choose under IRC § 174 to deduct R&D expenses currently or to amortize such expenses, the relevant regulations are based on the assumption that taxpayers can – and often must – factually identify current R&D expenses with specific future products or projects. See Treas. Reg. §§ 1.174-1, 1.174-2, 1.174-3, 1.174-4.

then have had a logical or 'factual' relationship to its future income and could then be said to be 'properly attributable' to that income as it is earned." U.S. Br. 41. See also *id.* at 24, 25 n.16. The government therefore recognizes that there *is* a definite, factual relationship between R&D costs and the income from the sale of the particular products those costs helped develop, albeit income that is realized in future years. Simply because the costs are deducted currently rather than capitalized, they do not magically become related to income from *current sales of unrelated products* – a transformation that is deemed to occur by Treas. Reg. § 1.861-8(e)(3).[5]

b. As this last point suggests, there also is a related internal inconsistency in the government's position. As we have noted, the government insists that there is no "definite relationship" between R&D expenses and *any* current income when the taxpayer deducts those expenses immediately, because the income produced by the R&D will be received in future tax years. But the regulation the government is defending has quite a different premise: Treas. Reg. § 1.861-8(e)(3) says that R&D expenses *are* definitely related to *all of that year's income* in the relevant SIC Code. The government therefore is forced to do a quick sidestep and defend the regulation on the ground that, because "[t]he relationship of a research cost to any discrete product is inherently tenuous and difficult to determine" (U.S. Br. 26), the Secretary is free

[5] Put another way, if a taxpayer's R&D produced income in the *same* tax year as the expenditure, even the government presumably would admit that the factual link would not be "severed." Thus, the "time displacement" rationale should not support reapportionment of *those* R&D expenses. Nonetheless, Treas. Reg. § 1.861-8(e)(3) would mechanically reapportion even those expenses to all current income related to the broad SIC Code. It thus is Treas. Reg. § 1.861-8(e)(3) itself that severs the factual link between expenses and income.

arbitrarily to assign such costs to broad product categories. See *id.* at 26-28.

This smorgasbord of arguments, however, simply makes vivid the weakness of the government's position. The government admits in its brief – indeed, it stresses – that R&D inherently gives rise to future-year income. And it acknowledges that there *is* a definite factual connection between research expenditures and future income when those expenses are capitalized. Yet the regulation defended by the government irrationally deems R&D to give rise exclusively to *current-year income* with which the R&D *has no factual connection whatever*. Thus, in this case, the government would require that R&D expenses relating to the improvement of a part unique to an airplane model not yet in production be assigned to current income from the sale of a different type of airplane – a type of airplane that, since it already has been produced, necessarily could not have benefited from that R&D. There is no plausible rationale for such a result.

c. The government also is incorrect in arguing that the Secretary is entitled to allocate R&D costs however he sees fit because the alternative is "to leave this determination to the vagaries of the management and accounting practices of individual taxpayers." U.S. Br. 28. We do not contend that each taxpayer's accounting system has the force of law; rather, the taxpayer's choices must be given effect where they comply with DISC's requirements. And here, it is undisputed that Boeing's approach does conform to the standards set out in the Secretary's own DISC regulations, which (as we explain in more detail below) allow taxpayers to calculate CTI on the basis of individual transactions, recognized industry or trade usage, *or* SIC Code. See Treas. Reg. § 1.994-1(c)(7). In this case, the Secretary has never challenged Boeing's product line groupings and, indeed, has approved the use of those groupings in allocating revenues and

all costs *other than R&D*. The Secretary's conduct therefore itself refutes the government's position.

3. The government gets no further when it argues, on the basis of the FSC statute's legislative history, that Congress meant to ratify the application of Treas. Reg. § 1.861-8(e)(3) to DISCs and FSCs. See U.S. Br. 32-34. Even the Ninth Circuit was not persuaded by this argument, concluding that the materials cited by the government "provide[] no reliable indication of how this case should be resolved." Pet. App. 13a. See *id.* at 12a-13a & n.10.[6]

The government relies on two separate snippets of legislative history to support its ratification argument. *First*, it points to a congressional staff report stating that, "where the provisions of the [FSC] bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations under those provisions will be applied to the FSC." STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 636 (Comm. Print 1984). From this, the government would have the Court infer that Congress meant to ratify the application of Treas. Reg. § 1.861-8(e)(3) to DISCs and FSCs. See U.S. Br. 32.

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[6] Even if the government's reading of the legislative history were correct, "re-enactment cannot save a regulation which 'contradict[s] the requirements' of the statute itself. When a regulation conflicts with the statute, the fact of subsequent re-enactment 'is immaterial, for Congress could not add to or expand [the] statute by impliedly approving the regulation.'" *Leary* v. *United States*, 395 U.S. 6, 25 (1969) (citations omitted). Here, for reasons explained above, Treas. Reg. § 1.861-8(e)(3) cannot be reconciled with the statutory language.

Whatever the value of the staff report as a guide to Congress's intent in the DISC and FSC statutes, the government plainly misreads that document. The staff report says only that Congress intended the same rules to apply under DISC and FSC. And "the regulations under [the DISC] provisions" alluded to in the report provide that the costs "relating to gross receipts" are those costs "definitely related" thereto, as well as a ratable portion of other expenses "which are not definitely related to a class of gross income" (Treas. Reg. § 1.994-1(c)(6)(iii)) – the very rule we are contending for here. That, presumably, is the approach that the staff had in mind when it said that similar rules should be applied under FSC. In contrast, the DISC regulations made no express reference to special rules for R&D. There simply is *no* evidence that Congress had such special R&D rules in mind when its staff generally approved use of the DISC regulations for FSC purposes.

The government tries to finesse this problem by asserting that "[t]he DISC regulations to which Congress referred expressly incorporate the cost allocation rules of 26 C.F.R. 1.861-8(e)(3)." U.S. Br. 32. But that assertion is inaccurate. The DISC regulations in fact state that cost allocations and apportionments are to be performed "in a manner consistent with the rules set forth in § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii). They do not "expressly incorporate" the particular rule of Treas. Reg. § 1.861-8(e)(3), which, as we have explained (see Pet. Br. 26 n.14), is a significant deviation from, and is *not* consistent with, either the other rules of Treas. Reg. § 1.861-8 or the general principles of § 861.

Second, the government is equally mistaken when it attempts to find support for its current position in the legislative history of a congressional moratorium that precluded the application of the R&D cost-allocation regulation when determining the geographic *source* of income. See U.S. Br. 32-

33. That moratorium provision, originally enacted in § 223(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 249, provided that, for a two-year period, "all research and experimental expenditures (within the meaning of sections 174 of the Internal Revenue Code of 1954) which are paid or incurred in such year for research activities conducted in the United States shall be allocated or apportioned to sources within the United States." This moratorium on the application of the R&D provisions of Treas. Reg. § 1.861-8 for sourcing purposes was modified and extended several times by subsequent legislation.[7] The government now points to the legislative history of the first of these extensions, which stated that the sourcing moratorium "does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier" (H.R. CONF. REP. NO. 98-861, at 1263 (1984)); the government takes this statement to express a congressional view that "the cost-allocation rules of 26 C.F.R. 1.861-8(e)(3) *are* controlling in the calculation of 'combined taxable income' not only for DISCs but also for FSCs." U.S. Br. 33 (emphasis in original).

[7] See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 126, 98 Stat. 494, 648; Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13211, 100 Stat. 82, 324; Tax Reform Act of 1986, Pub. L. No. 99-514, § 1216, 100 Stat. 2085, 2549; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4009, 102 Stat. 3342, 3653-54; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7111, 103 Stat. 2106, 2326-28; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11401(a), 104 Stat. 1388, 1388-472; Tax Extension Act of 1991, Pub. L. No. 102-227, § 101, 105 Stat. 1686, 1686; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13234, 107 Stat. 312, 504.

Again, however, the government reads something into this history that simply is not there. When Congress enacted the moratorium, it was concerned exclusively with the geographical *sourcing* of income, and it therefore limited the moratorium to that context. Congress nowhere indicated that it had examined and approved application of the R&D provision in any other context. Indeed, that it had not done so is made explicit by legislative history that the government fails to cite. In 1986, when Congress extended the moratorium for the third time (see note 7, *supra*), it declared that "[t]he conference agreement does *not* reflect a judgment by the conferees that any provision of the existing regulation is necessarily correct or incorrect." H.R. REP. NO. 99-426, at II-608 (1986) (emphasis added). Accord STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 960 (May 4, 1987). This congressional statement flatly contradicts the inference that the government asks the Court to draw from other portions of the legislative history.[8]

B. Taxpayer Choices As To Grouping Govern The Allocation And Apportionment Of Expenses

1. As explained in our opening brief (at 30-35), the DISC and FSC statutes and regulations allow taxpayers to choose

[8] We note that the Eighth Circuit held in 1994 that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to CTI. *St. Jude Med., Inc.* v. *Comm'r*, 34 F.3d 1394, 1402 (8th Cir. 1994). Six years later, Congress enacted the Extraterritorial Income Exclusion Act of 2000 ("ETI"), Pub. L. No. 106-519 § 3, 114 Stat. 2423, which contained provisions that were substantially similar to the CTI provisions of DISC and FSC. See Pet. Br. 3-4. If the Court were to entertain the possibility of legislative reenactment, it therefore could equally be said that Congress most recently reenacted these provisions with the understanding that Treas. Reg. § 1.861-8(e)(3) does *not* apply to the calculation of CTI.

how to group income and associated expenditures, permitting taxpayers to decide whether CTI determinations will be made on the basis of particular sales, on the basis of product groups recognized by industry usage, or on the basis of SIC Code groupings. Application of Treas. Reg. § 1.861-8(e)(3) to the calculation of CTI conflicts with this regime by requiring taxpayers to allocate R&D on the basis of SIC Code groupings in *all* instances. In response to this point, the government makes yet another argument that simply ignores what the DISC provisions actually say: it asserts that there is no conflict because the DISC grouping rules have nothing to do with the calculation of CTI and instead exist only so that taxpayers may "elect *which groups of sales* will be evaluated under one, or another, of the three alternative pricing methods" authorized by the DISC statute (*i.e.*, CTI, 4 percent of gross receipts, or arm's-length transfer price, see Pet. Br. 4 & n.4). U.S. Br. 43 (emphasis in original).

The government's contention that the taxpayer's grouping choice has no bearing on the allocation of expenses is demonstrably wrong. As explained in our opening brief (at 31, 34-35), the DISC regulations provide unequivocally that "the *determinations* under [Treas. Reg. § 1.994-1] are to be made * * * on the basis of" the taxpayer's chosen groupings. Treas. Reg. § 1.994-1(c)(7)(i) (emphasis added). See also Treas. Reg. § 1.925(a)-1T(c)(8) (same under FSC).[9] Those "determinations" include the matching of "gross receipts" with the costs "which relate to such gross receipts" in the calculation of CTI. See Treas. Reg. § 1.994-1(c)(6). There is

[9] The government unaccountably omitted this language from its presentation of the FSC regulations in the appendix to its brief in opposition to the petition for certiorari. Although we pointed out this oversight in our reply at the certiorari stage (at Pet. Br. 4 n.3), the government once again omits this key provision of the FSC regulations in the appendix to its merits brief. U.S. Br. 7a.

no room for doubt on this point: another provision of the DISC regulations – also quoted in our opening brief (at 35) – states that "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year *resulting from [the taxpayer's] grouping*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added).[10] Against this background, the government can deny the existence of a conflict between Treas. Reg. § 1.861-8(e)(3) and the DISC grouping provisions only by baldly misstating the nature of the controlling DISC provisions.

As we also argued in our opening brief (at 31-34), this conflict between the DISC regime and the R&D provision is fatal to the government's position here because the taxpayer flexibility reflected in the grouping rules is central to the congressional purpose underlying DISC and FSC. We explained that this flexibility was critical to the DISC legislation's function as a tax incentive and was sufficiently important that the taxpayer's entitlement to group transactions on the basis of product line or recognized industry usage was made explicit in the text of the FSC statute. IRC § 927(d)(2)(B) (1984). And it is undeniable, as the Eighth Circuit held in *St. Jude Medical* v. *Commissioner*, that application of Treas. Reg. § 1.861-8(e)(3), which overrides the taxpayer's grouping choice, clashes directly with the taxpayer-choice feature of the DISC regime. See 34 F.3d at 1401. The government makes absolutely no response to this point.

2. The government does argue that there can be no conflict between the DISC regime and the R&D provision because the "research expense allocation rules" were adopted

[10] The government quotes from this regulation (at U.S. Br. 42) but, curiously, edits out the language indicating that costs are to be allocated and apportioned according to the taxpayer's grouping decision.

"for the *express* purpose" of governing DISC CTI calculations and "would be made a nullity" if not applied in the DISC and FSC context. U.S. Br. 45 (emphasis in original); see *id.* at 22-23 & n.14, 44. But the R&D provision of Treas. Reg. § 1.861-8(e)(3) certainly was not promulgated specifically for the purpose of governing DISC calculations.[11] The general rules of Treas. Reg. § 1.861-8 apply for a multitude of international tax purposes and provide allocation rules for many types of expenses apart from R&D. See Treas. Reg. § 1.861-8(e), (f)(1). By contrast, the R&D provision was a small piece of the lengthy regulation, and the remainder of that regulation is consistent with (and may be applied to) the computation of DISC income. At the same time, the R&D rule may be applied in numerous contexts not involving the calculation of DISC CTI income. It therefore is ridiculous to suggest, as the government does, that any regulation would somehow be rendered nugatory if the R&D provision were held inapplicable to the computation of CTI.

The government also asserts that the DISC and R&D regulations cannot be thought to conflict because the former contains a cross-reference to the latter. U.S. Br. 44; see *id.* at 22 n.14. This argument, too, is built on moonbeams and wishful thinking. As we have explained, the conflict between the regulations is plain from their express terms. In addition, the cross-reference relied upon by the government was inserted at a time when all of the § 861 regulations *were consistent* with the DISC regime. See Pet. Br. 24-26. Moreover, that cross-reference, as noted above (at 11), refers

[11] The regulatory provision cited by the government for the proposition that use in DISC and FSC CTI calculations was "the *express* purpose for which [the R&D rule] was adopted" (U.S. Br. 45) in fact simply states that CTI calculations are one of the many areas to which the general-purpose § 1.861-8 regulations apply. See Treas. Reg. § 1.861-8(f)(1).

generally to Treas. Reg. § 1.861-8 and *not* to the specific R&D exception of Treas. Reg. § 1.861-8(e)(3), which was added years after the enactment of DISC. The DISC rules that deal with grouping (and specifically provide that costs are to be assigned in conformance with the taxpayer's grouping decisions), meanwhile, do *not* contain a cross-reference to the § 861 regulations. The cross-reference therefore simply cannot bear the weight placed upon it by the government.

Given Treas. Reg. § 1.861-8(e)(3)'s patent inconsistency with the DISC statute and regulations and every other indicium of congressional intent regarding DISC, we suggested in our opening brief (at 29) that it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply to the computation of CTI. The government ridicules this argument as frivolous on the ground that Treas. Reg. § 1.861-8 states that its provisions apply to the computation of CTI. U.S. Br. 22 n.14. But Treas. Reg. § 1.861-8(e)(3) by its *own* terms specifies R&D allocation rules that apply only "ordinarily," which necessarily must mean that those rules do not *always* apply for one or more of the purposes for which Treas. Reg. § 1.861-8 otherwise generally is applicable. The government has no answer to this argument.

In any event, the government's quixotic attempt to reconcile the conflicting regulations misses the real point. As we also suggested in our opening brief (at 29), it does not ultimately matter whether the Secretary intended Treas. Reg. § 1.861-8(e)(3) to govern the calculation of CTI because such an outcome is inconsistent with the plain terms and manifest purpose of the DISC statute and regulations. Again, the government makes no response to that point.

C. The Secretary's Current View Is Not Entitled To Deference

Ultimately, the government's argument reduces to a naked request that the Court defer to the Secretary's application of Treas. Reg. § 1.861-8(e)(3). See U.S. Br. 19-22. But whether or not that regulation is thought to be "legislative" in character, as the government maintains,[12] it is black letter law that deference is inappropriate when the agency's view is inconsistent with the governing statute. See, *e.g.*, *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 26 (1982); *United States* v. *Larionoff*, 431 U.S. 864, 871-873 (1977). And for reasons we have explained, that manifestly is the case here.

Although that should be the end of the matter, we note that the government also is wrong in asserting that our argument "ignores the settled rule that the agency's interpretation of its own regulations is 'entitled to controlling weight unless it is plainly erroneous or inconsistent with the regulation.'" U.S. Br. 45. As discussed above, the government's application of the R&D provision *is* inconsistent with the DISC regulations and is thus *not* entitled to any weight. Furthermore, as we argued in our opening brief, the general R&D provision should yield to the specialized DISC regulations that were specifically designed to govern CTI determinations. See Pet. Br. 29; see also *Busic* v. *United States*, 446 U.S.

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[12] The government quotes (but carefully does not itself endorse) the Ninth Circuit's statement that Treas. Reg. § 1.861-8(e)(3) is "legislative" because it was issued pursuant to the grant of authority provided by IRC § 863(a). U.S. Br. 19. In fact, as the Eighth Circuit observed in *St. Jude Medical*, "Section 1.861-8(e)(3) was *not* promulgated pursuant to a specific grant of authority." 34 F.3d at 1400 n.11 (emphasis added). Instead, the "general R&D allocation rules, applicable to multiple operative sections of the Code, were promulgated pursuant to the Commissioner's *general* grant of authority in I.R.C. § 7805(a)." *Ibid.* (emphasis added).

398, 406 (1980) ("[A] more specific statute will be given precedence over a more general one, regardless of their temporal sequence."). After all, the DISC regulation "was promulgated to interpret the DISC intercompany pricing rules," while Treas. Reg. § 1.861-8 "was promulgated to 'state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined.' Treas. Reg. § 1.861-8(a)(1)." *St. Jude Med.*, 34 F.3d at 1402 It is the former that should control the determination of DISC CTI.

* * * * *

The most remarkable aspect of the government's brief is that it does not offer *any* affirmative argument for its position; it does not even attempt to find support for its approach in the statutory language or policy, or explain how its application of the R&D provision advances the congressional purpose underlying the DISC statute. Instead, placing all its bets on its appeal to deference, the government seeks to persuade the Court that the language, background, legislative history, and contemporaneous agency construction of the DISC statute provide *no* guidance on how costs are to be allocated to income when CTI is calculated. But the government is able to make that assertion only by *ignoring* the language, background, legislative history, and contemporaneous agency construction of the DISC statute, all of which *do* provide clear guidance on the point – *i.e.*, the taxpayer's choice of grouping is controlling and costs related to one group may *not* be allocated to revenues in another. Because the government cannot blink away these sources of authority, it should not prevail here.

CONCLUSION

For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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THE BOEING COMPANY AND
CONSOLIDATED SUBSIDIARIES,

Petitioners,

-v.-

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR NATIONAL FOREIGN TRADE COUNCIL, INC., AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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S. Rep. No. 92-437, (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918 ..... 5, 6, 7, 17, 19

T.D. 7364, 1975-2 C.B. 315 22

T.D. 7456, 1977-1 C.B. 200 23

Technical Memorandum accompanying Treas. Reg. § 1.861-8, 1974 TM Lexis 30 (Oct. 29, 1974) 24-25

INTEREST OF *AMICUS CURIAE*

National Foreign Trade Council, Inc. ("NFTC"), is a not-for-profit corporation with over 300 member firms that are involved in international trade and investment.[1] NFTC is the oldest and largest U.S. business association exclusively devoted to international trade matters. NFTC's members, which include most of the largest U.S. manufacturing companies, account for a substantial percentage of all U.S. non-agricultural exports.

Members of NFTC have a vital interest in this case, which involves the resolution of a significant issue concerning federal income tax incentives for U.S. exporters. The decision below permits a Treasury regulation relating to the allocation of research and development ("R&D") expenses to undermine the intended operation of the domestic international sales corporation ("DISC") and foreign sales corporation ("FSC") provisions of the Internal Revenue Code, thereby depriving U.S. exporters of congressionally mandated tax benefits.

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[1] As required by Sup. Ct. R. 37.6, NFTC affirms that no counsel for a party in this case authored this brief in whole or in part and, furthermore, that no person or entity, other than NFTC, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties consented to the filing of this brief; their written consents have been lodged with the Clerk of the Court.

PRELIMINARY STATEMENT

Congress enacted the DISC provisions of the Internal Revenue Code (I.R.C. §§ 991-997) in 1971 to encourage exports.[2] The DISC provisions permit U.S. taxpayers to obtain tax benefits by using a separate company — a DISC — as a vehicle for making export sales. A DISC is not itself subject to federal income tax. I.R.C. § 991(a). Instead, a tax is imposed at the shareholder level on approximately half of the DISC's profits. I.R.C. § 995(b). The remainder of the DISC's profits are generally not taxed until actually distributed. I.R.C. § 996. Since the benefit derived from a DISC is deferral of tax on approximately half of the DISC's earnings, it is to the taxpayer's advantage to maximize DISC profits. There are three methods available to determine the amount of a DISC's profits, and the taxpayer is entitled to use the one that produces the highest profits for the DISC. I.R.C. § 994(a).[3] One of the methods is the combined taxable income ("CTI") method. Under that method, a DISC is assigned 50 percent of the CTI of the DISC and its related supplier which is attributable to an export sale. I.R.C.

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[2] Unless otherwise indicated, all "§" references are to the Internal Revenue Code of 1954 (26 U.S.C.), or the Treasury regulations promulgated thereunder (26 C.F.R.), as in effect in 1979. Because there are no differences between the DISC and FSC provisions that are relevant to the issue in this case, this brief will discuss only the DISC rules, as did the court below. *See* Opin. 6a n.3. ("Opin." references are to the opinion of the court of appeals in this case, as reproduced in Appendix A to the Petition for a Writ of Certiorari.)

[3] Technically, these three methods are not applied directly to determine the amount of the DISC's profits. Rather, they are applied to "back into" the allowable intercompany transfer price between a DISC and its related supplier (typically its parent corporation). The profits of the DISC and the related supplier are then computed on the basis of that transfer price.

§ 994(a)(2). The dispute in this case centers on how R&D expenses should be taken into account in computing CTI.

Prior to 1984, The Boeing Company and Consolidated Subsidiaries ("Boeing") exported commercial aircraft through a DISC subsidiary. Boeing maintained a separate "Program" for each of its aircraft models. Boeing conducted two types of R&D: (1) "Blue Sky R&D" (basic R&D and R&D with respect to potential new models) and (2) "Program R&D" (R&D directly related to a particular aircraft model that the company had decided to produce). *See* Opin. 2a-3a.

The CTI attributable to an export sale equals the gross receipts from the sale minus the costs of the DISC and its related supplier that relate to the gross receipts. Treas. Reg. § 1.994-1(c)(6). Boeing elected to determine CTI by product lines. Treas. Reg. § 1.994-1(c)(7)(i). Accordingly, Boeing computed the CTI for each Program by taking the gross receipts from export sales in that Program and subtracting the costs related to those gross receipts. In computing CTI for each Program, Boeing took into account all of the Program R&D expenses associated with that particular Program (as well as a portion of the Blue Sky R&D expenses). The court below rejected Boeing's approach and held that Treas. Reg. § 1.861-8(e)(3) required Boeing to take into account a ratable portion of the total R&D expenses for all Programs in computing CTI for each separate Program. Consequently, the amount of CTI for a particular Program would be reduced by a portion of the R&D expenses associated with a different Program. The Eighth Circuit, in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994), had previously held that Treas. Reg. § 1.861-8(e)(3) could not be validly applied in such a fashion in the computation of CTI.

SUMMARY OF ARGUMENT

The Eighth Circuit got it right in *St. Jude Medical*. The Ninth Circuit got it wrong. The decision below is based on a fundamental misunderstanding. The DISC legislative history, the DISC regulations, and Treas. Reg. § 1.861-8 all recognize only two categories of deductions: (1) those that are *definitely* related to *some* gross income and (2) those that are *not* definitely related to *any* gross income. The court below concocted another category: deductions that are *indefinitely* related to *some* gross income. Only on the basis of that concoction was the court able to conclude that Treas. Reg. § 1.861-8(e)(3) does not conflict with Congress' intent and the DISC regulations.

As written, Treas. Reg. § 1.861-8(e)(3) cannot be validly applied in computing DISC CTI. Since the DISC regulations do not mandate that Treas. Reg. § 1.861-8(e)(3) be applied mechanically, it should be applied, if at all, *mutatis mutandis* on the basis of the taxpayer's product lines, rather than on the basis of broad product categories. That way, Treas. Reg. § 1.861-8(e)(3) can be harmonized with the DISC regulations and applied to effectuate, rather than thwart, Congress' intent.

ARGUMENT

I. THE NINTH CIRCUIT ERRED IN HOLDING THAT TREAS. REG. § 1.861-8(e)(3) COULD BE VALIDLY APPLIED TO REQUIRE R&D EXPENSES TO BE ALLOCATED AND APPORTIONED ON THE BASIS OF BROAD PRODUCT CATEGORIES RATHER THAN BOEING'S CTI PRODUCT LINES.

A. The Decision Below Was Based on a Fundamental Misunderstanding of the Provisions Involved.

The Ninth Circuit held that Treas. Reg. § 1.861-8(e)(3) could be validly applied to require Boeing to subtract R&D expenses related to *one* product line in computing DISC CTI for *other* product lines. That holding was premised on a fundamental misunderstanding of how Treas. Reg. § 1.861-8 and the DISC provisions work. The court of appeals' reasoning is fatally flawed and should be rejected.

1. The DISC provisions

Under the CTI method, the CTI of a DISC and its related supplier that is attributable to a sale of export property is split 50-50 between the DISC and the related supplier. I.R.C. § 994(a)(2). The legislative history of I.R.C. § 994 indicates that Congress intended for the CTI attributable to a sale of export property to be determined "generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 92-533, at 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 92-437, at 107 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013. Congress summarized those "principles" in this way: "These

rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." *Id.* The committee reports continue:

> Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.

H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1887-88; S. Rep. No. 92-437, at 107-08, *reprinted in* 1971 U.S.C.C.A.N. at 2013-14.

Consistent with the legislative intent, the DISC regulations define CTI from a sale of export property as "the excess of gross receipts . . . of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts." Treas. Reg. § 1.994-1(c)(6). The regulations further provide:

> Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated

> and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii).

Thus, both the legislative history and the DISC regulations contemplate two types of costs that are to be deducted from gross receipts to determine CTI: (1) all costs "directly" or "definitely" related to the gross receipts (cost of goods sold, selling expenses, overhead, and administrative expenses are mentioned) and (2) a portion of other expenses that are not "allocable" or "definitely related" to a specific item or class of gross income, which are to be spread ratably over all of the gross income of the DISC and the related supplier.

The pricing rules embodied in I.R.C. § 994 (including the CTI method) "generally are to be applied on a product-by-product basis" but "may be applied on the basis of product lines." H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1888; S. Rep. No. 92-437, at 108, *reprinted in* 1971 U.S.C.C.A.N. at 2014. The DISC regulations provide that, "[g]enerally, the determinations under [Treas. Reg. § 1.994-1] are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). The regulations go on to state that a taxpayer's determination of a product or product line "will be accepted" by the Internal Revenue Service ("IRS") as long as it conforms to "a recognized industry or trade usage" or to "the two-digit major groups (or any inferior classifications or combinations thereof, within a major group)" of the Office of

Management and Budget's Standard Industrial Classification ("SIC") Manual. Treas. Reg. § 1.994-1(c)(7)(ii).

Finally, the DISC regulations provide an explicit link between the allocation and apportionment of costs to export-related gross receipts and the taxpayer's choice of transaction groupings: "In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, . . . [t]he taxpayer's choice in accordance with [Treas. Reg. § 1.994-1(c)(7)] as to the grouping of transactions shall be *controlling*, and costs deductible in a taxable year shall be *allocated and apportioned to the items or classes of gross income . . . resulting from such grouping.*" Treas. Reg. § 1.994-1(c)(6) (emphasis added).

2. Treas. Reg. § 1.861-8

Treas. Reg. § 1.861-8 is a provision of general application that "prescrib[es] rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively . . . as 'deductions')" for purposes of "determining taxable income of the taxpayer from specific sources and activities" under various sections of the Internal Revenue Code, referred to as "operative sections." Treas. Reg. § 1.861-8(a)(1). After the gross income from the relevant source or activity has been determined, the amounts that must be subtracted to reach taxable income are determined under a two-step process: The taxpayer's deductions are first *allocated* and then they are *apportioned.*

Generally, a deduction is *allocated* to the "class of gross income" to which the deduction is "definitely related." Treas. Reg. § 1.861-8(b)(1). "The classes of gross income are not predetermined but must be determined on the basis of the

deductions to be allocated." *Id.* Thus, a "class of gross income" may consist of more than one type or category of gross income. The rules for determining the class of gross income to which a deduction is definitely related "emphasize the factual relationship between the deduction and a class of gross income." *Id.* A deduction is "considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." Treas. Reg. § 1.861-8(b)(2).

The regulations indicate that most deductions will be definitely related to some class of a taxpayer's total gross income. Treas. Reg. § 1.861-8(b)(1). If a deduction is not definitely related to some class of a taxpayer's total gross income, it is ordinarily "treated as definitely related and allocable to *all* of the taxpayer's gross income." Treas. Reg. § 1.861-8(b)(5) (emphasis added). Only a handful of specified deductions (e.g., those for charitable contributions, real estate taxes on a personal residence, and medical expenses) are treated as not definitely related to *any* gross income. Treas. Reg. § 1.861-8(e)(9).

Where a deduction is allocated to a class of gross income that is included in one or more "statutory groupings" of gross income and the "residual grouping" of gross income, the deduction must then be *apportioned* between (or among) the statutory grouping(s) and the residual grouping. Treas. Reg. § 1.861-8(c)(1).[4] For purposes of calculating DISC CTI, there would be a statutory grouping for each CTI product line

[4] "Statutory grouping" means "the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative

(footnote continued)

consisting of the gross income (i.e., the DISC's gross receipts minus the related supplier's cost of goods sold) from sales of the product line.

A deduction is apportioned by attributing the deduction to the statutory grouping(s) and the residual grouping. "Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income." *Id.*[5] Where a deduction is treated as not definitely related to *any* gross income, however, the deduction is always *ratably* apportioned between (or among) the statutory grouping(s) and the residual grouping — i.e., the same proportion of the deduction is apportioned to each grouping as the amount of gross

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(footnote continued)

section. . . . Gross income from other sources or activities is referred to as the . . . 'residual grouping.'" Treas. Reg. § 1.861-8(a)(4). Thus, for example, if the operative section required the determination of taxable income from Virgin Islands sources, the statutory grouping would be the taxpayer's gross income from Virgin Islands sources and the residual grouping would be all the taxpayer's other gross income.

[5] Examples of "bases and factors" that should be considered in determining the method of apportionment for a particular deduction include:

(i) Comparison of units sold;
(ii) Comparison of the amount of gross sales or receipts;
(iii) Comparison of costs of goods sold;
(iv) Comparison of profit contribution;
(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income; and
(vi) Comparison of the amount of gross income.

Treas. Reg. § 1.861-8(c)(1).

income in the grouping bears to the total amount of gross income. Treas. Reg. § 1.861-8(c)(2).

Treas. Reg. § 1.861-8(e) contains special rules for the allocation and apportionment of specific types of deductions (e.g., interest, legal and accounting fees, and income taxes). Treas. Reg. § 1.861-8(e)(3) provides the specific rules for the allocation and apportionment of R&D expenses. That regulation states that R&D expenses are ordinarily considered "deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class . . . related to such product category (or categories)." Treas. Reg. § 1.861-8(e)(3)(i)(A). If the R&D is not clearly identified with any product category (or categories), it is considered to be conducted with respect to all the taxpayer's product categories. *Id.* The regulation goes on to list the "broad product categories" to which a taxpayer is limited. Those categories are based on the SIC two-digit major groups.[6]

Treas. Reg. § 1.861-8(e)(3) departs from the over-arching "factual relationship" standard enunciated in Treas. Reg. § 1.861-8(b)(1). It departs from the principle that classes of gross income are not predetermined. It requires taxpayers to allocate R&D expenses to all the gross income in a broad, predetermined SIC product category — including gross income to which the expenses may bear *no* factual relationship. In the context of DISC CTI computations, if applied literally, it would require taxpayers to treat R&D expenses

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[6] The "broad product categories" encompass anywhere from one to 15 SIC major groups. All of Boeing's Programs fell within the broad product category "transportation equipment" (SIC major group 37).

that are factually related to *one* CTI product line as costs relating to export sales in *other* CTI product lines.

3. The decision below

The Ninth Circuit concluded that Treas. Reg. § 1.861-8(e)(3)'s imposition of a "deemed" relationship between R&D expenses and broad, predetermined categories of gross income is consistent with the legislative history of the DISC provisions and with the DISC regulations. The court misinterpreted the legislative history, the DISC regulations, and Treas. Reg. § 1.861-8(e)(3), all of which recognize only two types of deductions: (1) deductions that are *definitely* (or directly) related to *some* gross income and (2) deductions that are *not* definitely (or directly) related to *any* gross income. The court of appeals, in its confusion, thought there was a third, hybrid category of deductions — those that are "indefinitely" related to *some* gross income. The court was thus able to view R&D expenses that were clearly identified with *one* of Boeing's CTI product lines as "indefinitely" related to *all* of its product lines.

First, the court explained, "House Report [92-533] reflects that Congress recognized some of the costs incurred in a given tax year would not be 'directly related' to specific income items. The report further reflects Congress' intention that those costs not 'directly related' would be allocated [sic] to export-related sales on a pro rata basis." Opin. 11a. The court concluded that "[t]he Commissioner's application of Treas. Reg. § 1.861-8(e)(3) effectuates this Congressional intent." *Id.* The court of appeals was also able to conclude that "[t]here is no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)." Opin. 12a. The court reasoned:

> Treas. Reg. § 1.994-1(c)(6) contemplates that costs which are not "definitely related" to specific items of income . . . will be allocated [sic] to the combined taxable income of the taxpayer's export-related business. Treas. Reg. § 1.994-1(c)(6) is clear in explaining that "total costs . . . which relate to" . . . export sales . . . include both "definitely" and "indefinitely" related costs.

Id.

The problem with the court's reasoning is that Treas. Reg. § 1.861-8(e)(3) simply does not treat R&D expenses as not "directly" or "definitely" related to any class of gross income, or as "indefinitely" related to some gross income. Rather, it deems R&D expenses to be *definitely related*, and therefore *allocable*, to either (1) the gross income related to the broad SIC product category (or categories) with which the R&D is clearly identified or (2) the gross income related to all the taxpayer's SIC product categories (if the R&D is not clearly identified with any particular SIC product category (or categories)). The fact that Congress intended, and Treas. Reg. § 1.994-1(c)(6)(iii) requires, a ratable portion of "nonallocable" expenses (expenses that are ratably *apportioned* to *all* of the taxpayer's gross income) to be taken into account in the computation of CTI provides no basis for sustaining Treas. Reg. § 1.861-8(e)(3)'s treatment of R&D expenses that are clearly identified with *one* CTI product line as "definitely related," and therefore *allocable*, to the gross income from other CTI product lines.

Finally, the court below concluded:

> To the extent there is any tension between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7),

> the regulations can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion [sic] these costs to broader categories of income and allocate [sic] them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3). Interpreted in this way, the regulations may be read to give effect to both.

Opin. 12a.

The Ninth Circuit's attempt at "harmoniz[ation]" does not make any sense. It is based entirely on the court's own amorphous concept of "indirectly" or "indefinitely" related costs — a concept that is to be found in neither Treas. Reg. § 1.861-8(e)(3) nor the DISC regulations.

Contrary to the Ninth Circuit's view, the more narrowly a taxpayer chooses to define items or categories of income, the more costs may become *definitely* related to more than one item or category of income. If a taxpayer makes red and blue widgets and chooses to "define" its income as "income from red widgets" and "income from blue widgets" (instead of simply as "income from widgets"), its widget-related costs do not suddenly become "indirectly" or "indefinitely" related to its red-widget income and blue-widget income. Those costs certainly do not become "not definitely related" to *any* item or category of gross income (and thus ratably apportionable to *all* the taxpayer's gross income, including interest, dividends, and income from any other lines of business the taxpayer may have). Rather, those costs (other than costs related solely to the widgets' redness or blueness)

become *definitely* related to two categories of income — the red-widget income and the blue-widget income.

When a taxpayer chooses under Treas. Reg. § 1.994-1(c)(7) to group DISC transactions by product lines (rather than broader categories), more R&D expenses may be definitely related to more than one CTI product line — if, in fact, the R&D is clearly identified with more than one product line. But under the Ninth Circuit's application of Treas. Reg. § 1.861-8(e)(3) in the computation of CTI, Boeing's choice as to the grouping of transactions is made irrelevant. Under the Ninth Circuit's reading, for purposes of allocating R&D expenses, Boeing is treated as if it had chosen to group transactions in accordance with the broad SIC categories. As a result, the expenses for R&D clearly identified with only one CTI product line are treated as definitely related to the income from all of Boeing's CTI product lines. The Ninth Circuit's reading ignores the significance conferred by the DISC regulations on Boeing's choice of transaction groupings.

The decision below is hopelessly flawed. It attempts to "harmonize[]" Treas. Reg. § 1.861-8(e)(3) with the DISC regulations on the basis of the court's mistaken beliefs that the DISC regulations require "indirectly" or "indefinitely" related costs to be taken into account in computing CTI and that Treas. Reg. § 1.861-8(e)(3) treats Boeing's R&D expenses as "indirectly" or "indefinitely" related to the income from all of Boeing's CTI product lines. The fundamental premise justifying the Ninth Circuit's decision is simply wrong.

B. The Literal Language of Treas. Reg. § 1.861-8(e)(3) Cannot Be Harmonized with the DISC Regulations.

Unlike the Ninth Circuit, the Eighth Circuit in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994), found an irreconcilable conflict between Treas. Reg. § 1.994-1, which permits a taxpayer to compute CTI on the basis of product lines, and Treas. Reg. § 1.861-8(e)(3), which requires the allocation of R&D expenses to the income from broad SIC categories. The Eighth Circuit found that "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines," and that "the deemed relationship mandated by § 1.861-8(e)(3)(i) is inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related thereto.*'" 34 F.3d at 1401. Based on "the origin and purpose of the DISC statute," the court held that Treas. Reg. § 1.861-8(e)(3) is "unreasonable, and thus invalid, as applied to DISC CTI computations." 34 F.3d at 1402.

The Eighth Circuit got it right in *St. Jude Medical*. The literal language of Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the provisions of Treas. Reg. § 1.994-1. The DISC regulations clearly carry out Congress' intent in enacting the DISC provisions: In determining CTI from export sales, expenses *directly related* to the gross income from each of the taxpayer's chosen CTI product lines are to be allocated to that gross income. The Ninth Circuit's application of Treas. Reg. § 1.861-8(e)(3) in this case to compute Boeing's CTI is invalid. The decision below should be reversed.

II. TREAS. REG. § 1.861-8, AS INVOKED BY TREAS. REG. § 1.994-1(c)(6)(iii), SHOULD BE APPLIED *MUTATIS MUTANDIS* IN COMPUTING CTI BY TREATING THE TAXPAYER'S CTI PRODUCT LINES AS THE RELEVANT PRODUCT CATEGORIES.

A. Treas. Reg. § 1.861-8(e)(3) Can Be Harmonized with the DISC Regulations by Applying the Methodology of Treas. Reg. § 1.861-8(e)(3) to CTI Product Lines Instead of SIC Categories.

The Ninth Circuit rightly recognized that it should, if possible, harmonize Treas. Reg. § 1.861-8(e)(3) with Treas. Reg. § 1.994-1(c)(7) so that "the regulations may be read to give effect to both. See, *e.g.*, *United States v. Borden Co.*, 308 U.S. 188, 198, 84 L. Ed. 181, 60 S. Ct. 182 (1939) ('It is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject, the rule is to give effect to both if possible.'); *see also Black & Decker Corp. v. Commissioner*, 986 F.2d 60, 65 (4th Cir. 1993) (explaining that the tenets of statutory construction apply with equal force to the interpretation of regulations)." Opin. 12a. The fact that the Ninth Circuit's attempt at harmonization was hopelessly flawed does not mean that harmonization is impossible.

The legislative history of the DISC provisions states that CTI is to be determined "generally in accordance with the principles applicable under section 861." H.R. Rep. No. 92-533, at 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 92-437, at 107 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013. Treas. Reg. § 1.994-1(c)(6)(iii) requires that the costs definitely related to the gross receipts from a CTI product line and a ratable portion of the costs not

definitely related to a class of gross income be "determined in a manner consistent with the rules set forth in Treas. Reg. § 1.861-8." The cross-reference to Treas. Reg. § 1.861-8 "does not mean that the very words of [that provision] must be lifted bodily from their context and applied mechanically" in the computation of CTI. *Cox v. Roth*, 348 U.S. 207, 209 (1955); *see also Bowen v. Michigan Academy of Family Physicians*, 476 U.S. 667, 673 (1986); *Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 18 (2000). Certainly, nothing in the cross-referencing language suggests that Treas. Reg. § 1.861-8(e)(3) should be "lifted bodily" and "applied mechanically" in the computation of CTI to the extent that provision is inconsistent with the DISC regulations.

If a taxpayer's CTI product lines are substituted for the SIC product categories, Treas. Reg. § 1.861-8(e)(3) can be harmonized with the DISC regulations. Interpreted in this way, Treas. Reg. § 1.861-8(e)(3) effectuates, rather than overrides, the DISC regulations' prescriptions that (1) costs treated as relating to gross receipts from sales of export property include "the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto," Treas. Reg. § 1.994-1(c)(6)(iii), and (2) the taxpayer may choose to make the determinations under Treas. Reg. § 1.994-1 on the basis of product lines, Treas. Reg. § 1.994-1(c)(7). Thus, for purposes of computing DISC CTI, R&D deductions should "ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant [CTI product line (or lines)] of the taxpayer and therefore allocable to all items of gross income as a class related to such [CTI product line (or lines)]." Treas. Reg. § 1.861-8(e)(3)(i)(A). Where R&D is "not clearly identified with any [CTI product line (or lines)], it [should] be considered conducted with respect to all the taxpayer's [CTI product lines]." *Id.* Any other approach

results in R&D that is factually related to one CTI product line being taken into account in computing CTI for other product lines. And that result is inconsistent with the structure and purpose of the DISC provisions.[7]

B. The Allocation and Apportionment of R&D Deductions on the Basis of CTI Product Lines, Rather Than SIC Categories, Is Consistent with the History and Policy of the Relevant Statutory and Regulatory Provisions.

The approach of applying Treas. Reg. § 1.861-8(e)(3) *mutatis mutandis* in computing DISC CTI is strongly supported by an examination of Treas. Reg. § 1.861-8 as it existed when Congress enacted the DISC provisions and when the Treasury Department promulgated the DISC regulations.

In 1971, Congress stated that expenses should be allocated and apportioned for purposes of CTI computations "generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1887; S. Rep. No. 92-437, at 107, *reprinted in* 1971 U.S.C.C.A.N. at 2013. Congress also indicated that "[t]hese rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." *Id.*

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[7] An illustration of the application of Treas. Reg. § 1.861-8(e)(3) *mutatis mutandis* in computing CTI is set forth in the Appendix to this brief.

In 1971, Treas. Reg. § 1.861-8, promulgated in 1957 and captioned "Computation of taxable income from sources within the United States," contained the following general rule, which merely reproduced the language of I.R.C. § 861(b):

> From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States *there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto* and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Treas. Reg. § 1.861-8(a) (1957) (emphasis added). The regulations contained no "rules" for determining *how* deductions were to be "properly apportioned or allocated" to income from U.S. sources.

Regulations proposed in 1966 restated the general rule quoted above almost verbatim. Prop. Treas. Reg. § 1.861-8(a)(1) (1966).[8] In addition, the proposed regulations contained rules for allocating and apportioning deductions. Under the proposed regulations, a deduction "definitely related" to gross income would be *allocated* and, if necessary, *apportioned* to such income. Prop. Treas. Reg. § 1.861-8(a)(2)(i) (1966). A deduction would be considered "definitely related" to gross income if it was "incurred in

[8] 31 Fed. Reg. 10,394, 10,405 (Aug. 2, 1966).

whole or in material part as a result of, or incidental to, the activities from which such gross income is derived." Prop. Treas. Reg. § 1.861-8(a)(3)(i) (1966).

Thus, when Congress enacted the DISC provisions, the "principles applicable under section 861" could be applied only by analogy in computing DISC CTI (since Treas. Reg. § 1.861-8 applied, by its terms, only to the calculation of taxable income from sources within the United States), and there were no "rules" on how to allocate and apportion expenses in the final regulations. The 1966 proposed regulations, however, had rules regarding the allocation and apportionment of "definitely related" expenses. Those are the "rules" that Congress paraphrased in the DISC legislative history.

The DISC regulations were proposed in 1972.[9] The proposed regulations provided that costs relating to gross receipts from sales of export property included "deductions *properly apportioned or allocated* thereto, . . . determined in a manner consistent with the rules set forth in § 1.861-8." Prop. Treas. Reg. § 1.994-1(c)(6)(iii) (1972) (emphasis added). Again, Treas. Reg. § 1.861-8 could apply only by analogy for purposes of computing CTI. That fact (together with the fact that Treas. Reg. § 1.861-8 (1957) contained no rules for "properly" apportioning or allocating deductions) presumably dictated the drafters' choice of the phrase "in a manner consistent with" when cross-referencing Treas. Reg. § 1.861-8. By contrast, the provision relating to cost of goods sold used the phrase "shall be determined *in accordance with the provisions* of § 1.61-3." Prop. Treas. Reg. § 1.994-1(c)(6)(ii) (1972) (emphasis added). Therefore, the origin of the cross-referencing language in Treas. Reg.

[9] 37 Fed. Reg. 19,625 (Sept. 21, 1972).

§ 1.994-1(c)(6)(iii) strongly supports the notion that Treas. Reg. § 1.861-8 need not be applied mechanically.

When the DISC regulations were finalized in 1975,[10] the 1966 proposed regulations had been replaced by Prop. Treas. Reg. § 1.861-8 (1973).[11] The 1973 proposed regulations were captioned "Computation of taxable income from sources within the United States and from other sources and activities." They provided rules for determining taxable income from specific sources and activities under various operative sections of the Internal Revenue Code.

The 1973 proposed regulations also provided specific rules for allocating R&D expenses:

> Expenditures for research and development . . . shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class. Where research and development is intended to create, or is reasonably expected to result in the creation of, specific intangible properties or processes, or is intended or is reasonably expected to result in the improvement of specific properties or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably expected to give rise. . . . In other cases, as in the case of most basic research, research and

[10] T.D. 7364, 1975-2 C.B. 315.

[11] 38 Fed. Reg. 15,840 (June 18, 1973).

> development shall generally be considered definitely related and therefore allocable to all gross income . . . which is likely to benefit from the research and development.

Prop. Treas. Reg. § 1.861-8(e)(3) (1973).[12]

The 1973 proposed regulations also contained an example which illustrates in no uncertain terms that, at the time the final DISC regulations cross-referenced Treas. Reg. § 1.861-8, R&D expenses were intended to be allocated as Boeing allocated its R&D expenses. Prop. Treas. Reg. § 1.861-8(g), *Example (1)* (1973), involved a domestic corporation (X) that manufactured 4-, 6-, and 8-cylinder engines. The example concluded that X's deductions for R&D expenses in connection with general research were definitely related to the gross income to which all engines gave rise. The example went on to deal with product-specific R&D and concluded that X's deductions for its R&D expenses in connection with the 4-cylinder engine, the 6-cylinder engine, and the 8-cylinder engine were, in each case, definitely related to the gross income to which the particular engine gave rise.

Prop. Treas. Reg. § 1.861-8(g), *Example (2)* (1973), dealt expressly with the computation of DISC CTI. X sold 4- and 6-cylinder engines to its wholly owned DISC (Y). The example noted that "X and Y group[ed] transactions on the basis of each of the two products sold (four- and six-cylinder

[12] The mandatory SIC product categories in Treas. Reg. § 1.861-8(e)(3) were first introduced in 1976 (after the DISC regulations were finalized), when the 1973 proposed regulations were withdrawn and new regulations were proposed. 41 Fed. Reg. 49,160 (Nov. 8, 1976). The 1976 proposed regulations were finalized in 1977. T.D. 7456, 1977-1 C.B. 200.

engines),"[13] with a specific cross-reference to Prop. Treas. Reg. § 1.994-1(c)(7) (1972), and "determine[d] transfer prices charged on the basis of the '50-50' combined taxable income method." The example concluded: "As the initial step in computing the deductions which must be taken into account for purposes of determining combined taxable income of X and Y from DISC sales, X's deductions for its research and development expenses (including expenses for general research) are allocated in the same manner as in example (1)."

These were the "rules set forth in § 1.861-8" when the DISC regulations were finalized. Just as the drafters of Prop. Treas. Reg. § 1.861-8 (1973) were clearly aware of the significance of the taxpayer's CTI product lines to the allocation and apportionment of R&D expenses for purposes of computing CTI, the drafters of the final DISC regulations were manifestly aware of the existence of the examples discussed above. The IRS Technical Memorandum that accompanied the proposed Treasury decision containing the 1975 final DISC regulations stated:

> Several comments [on the 1972 proposed DISC regulations] suggested that subdivisions (iii) and (iv) [of § 1.994-1(c)(6)] should be amplified to give rules and examples for determining the portion of certain expenses of the related supplier to be deducted in determining combined taxable income of the DISC and related supplier. *It was observed that the reference to § 1.861-8 is of no value without adequate regulations under that section, and that the thought in such subdivi-*

[13] Income from DISC sales of 4-cylinder engines and income from DISC sales of 6-cylinder engines were each treated as a statutory grouping.

> *sion (iii) is expressed in terms of the existing regulation rather than in terms of the outstanding [1966] proposed regulation.*
>
> Subsequent to receipt of these comments, a notice was published under § 1.861-8 on June 18, 1973 (38 F.R. 15840) which provides rules and examples for allocation and apportionment of expenses in determining combined taxable income of the DISC and related supplier. Hence, this suggestion was not adopted.

1974 TM LEXIS 30 at *20-21 (Oct. 29, 1974) (emphasis added).[14]

* * *

When it enacted the DISC provisions, Congress intended that each item of gross income would have allocated to it all "directly related" expenses (as well as a pro rata portion of "nonallocable" expenses). That was what Congress believed would be the result under "the principles applicable under section 861." Congress also intended that the DISC pricing rules could be applied on the basis of product lines.

The drafters of the DISC regulations carried out Congress' intent. Those regulations provide that (1) costs to

[14] A Technical Memorandum generally summarizes or explains proposed rules, provides background information, states the issues involved, identifies any controversial questions, discusses the approach taken by the drafter, and gives the reasons for that approach. *Taxation With Representation Fund v. Internal Revenue Service*, 646 F.2d 666, 671 (D.C. Cir. 1981). Although they do not have the authority of legislative history, Technical Memoranda provide similar evidence of the drafter's intentions.

be treated as relating to gross receipts from sales of export property include expenses "definitely related, and therefore allocated and apportioned, thereto" (as well as a ratable part of any other expenses not definitely related to a class of gross income), Treas. Reg. § 1.994-1(c)(6)(iii), and (2) at the taxpayer's election, determinations relating to CTI could be made on the basis of product lines, Treas. Reg. § 1.994-1(c)(7). The drafters believed that would be the result if costs were allocated and apportioned "in a manner consistent with the rules set forth in § 1.861-8."

Boeing allocated its product-specific R&D expenses only to the gross income from the relevant Program. That is what was intended by Congress, and that is what was intended by the drafters of the DISC regulations. That is also what a proper reading of the DISC regulations' cross-reference to Treas. Reg. § 1.861-8 will achieve.

Since a mechanical application of Treas. Reg. § 1.861-8(e)(3) does not achieve the result clearly intended both by the Congress that enacted the DISC provisions and by the drafters of the nearly contemporaneous DISC regulations, Treas. Reg. § 1.861-8(e)(3) should be interpreted, in the context of DISC CTI computations, as applying on the basis of the taxpayer's CTI product lines, rather than SIC categories. Such a reading both harmonizes Treas. Reg. § 1.861-8(e)(3) with the provisions of Treas. Reg. § 1.994-1 and carries out Congress' intent in enacting the DISC provisions. The decision below does neither.

CONCLUSION

The decision of the Ninth Circuit should be reversed. The Court should reverse either (1) on the same basis as the Eighth Circuit decided *St. Jude Medical*, holding Treas. Reg. § 1.861-8(e)(3) unreasonable, and therefore invalid, as applied in the computation of DISC CTI, or (2) on the ground that, properly interpreted in the context of the DISC provisions, Treas. Reg. § 1.861-8(e)(3) should be applied in the computation of CTI by treating the taxpayer's CTI product lines — rather than broad SIC categories — as the relevant product categories Under either approach, the decision below should be reversed.

Respectfully submitted,

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Allocation and Apportionment of R&D Deductions in Computing CTI

A U.S. corporation (X) manufactures product lines A, B, C, and D. X exports B, C, and D through its wholly owned DISC (Y). X and Y group transactions under Treas. Reg. § 1.994-1(c)(7) on the basis of the product lines sold by Y and use the CTI method. Sales for each product line are as follows:

	Domestic Sales	DISC Sales
A	600	-
B	-	800
C	400	1200
D	600	400

X has total R&D expenses of $100. Of that amount, $45 is for research related to A, $15 is for research related to B, and $40 is for research related to C. There is no research related to D.

Allocation

The R&D deductions are allocated $45 to the income from sales of A, $15 to the income from sales of B, and $40 to the income from sales of C.

Apportionment

There are three statutory groupings of gross income (income from DISC sales of B, income from DISC sales of C, and income from DISC sales of D). The residual grouping is other gross income (income from domestic sales).

The $45 R&D deduction allocated to the income from sales of A does not need to be apportioned because all the income from sales of A is in the residual grouping. The $15 R&D deduction allocated to the income from sales of B does not need to be apportioned because all the income from sales of B is in a single statutory grouping (income from DISC sales of B).

The $40 R&D deduction allocated to the income from sales of C is apportioned between the statutory grouping and the residual grouping based on the sales of C in each grouping:

					Grouping
DISC sales of C / Total sales of C	=	$1200 / $1600	x $40	= $30	*Income from DISC Sales of C*
Domestic sales of C / Total sales of C	=	$ 400 / $1600	x $40	= $10	*Residual*

Thus, X and Y deduct $15 in computing CTI from sales of B, $30 in computing CTI from sales of C, and nothing in computing CTI from sales of D.

(8)

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In The

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THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari To
The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF CATERPILLAR INC., HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, LEXMARK INTERNATIONAL, INC., REEBOK INTERNATIONAL LTD., AND UNITED TECHNOLOGIES CORP. IN SUPPORT OF PETITIONERS AND REVERSAL OF THE DECISION BELOW

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REEBOK INTERNATIONAL LTD., AND
UNITED TECHNOLOGIES CORP.
IN SUPPORT OF PETITIONERS AND
REVERSAL OF THE DECISION BELOW

INTEREST OF THE *AMICI CURIAE*

Amici Curiae are seven publicly held United States corporations representing a broad spectrum of industries,[1] including construction, mining, agricultural, and forestry machinery and engines, imaging and printing products and

[1] All parties to this proceeding have consented to the submission of this brief in letters of consent filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae,* made a monetary contribution to the preparation or submission of this brief.

systems, computing systems, microprocessors, chipsets, semiconductor and microelectronics testing equipment, data storage devices, sports and fitness products, and elevators, escalators, heating, ventilating, air conditioning and refrigeration equipment, aircraft engines, and flight systems products. Each company engages in significant research and development ("R&D") activities and is profoundly interested in the export laws of the United States and the tax incentives enacted by Congress.

Amici curiae are adversely affected by the United States Court of Appeals for the Ninth Circuit decision in this proceeding which is wrong as a matter of law, conflicts with important national interests, and presents an irreconcilable conflict with a 1994 decision in the Eighth Circuit. For companies engaged in R&D efforts and producing products for export, and for companies considering the advantages of commencing or expanding export activities, the decision below is a serious obstacle and is detrimental to such activities. The Ninth Circuit decision imposes financial disincentives on companies conducting vital R&D activities and dilutes the value of important provisions enacted by Congress to stimulate export activities.

Caterpillar Inc. ("CAT") is incorporated in the State of Delaware, with its principal executive offices located in Peoria, Illinois. CAT is a leading producer of construction, mining, agricultural, and forestry machinery. CAT is also engaged in the design and manufacturing of engines for such machinery, electric power generation systems, vehicles and locomotives, and petroleum, construction, and industrial applications. In 2001, CAT's worldwide consolidated sales exceeded $20 billion, and approximately 51 percent of such sales were outside the United States. CAT spent $898 million on research and engineering programs in 2001, of which $696 million related to new prime products, major

component development, and major improvements of existing products.

Hewlett-Packard Company ("HP") is incorporated in the State of Delaware, with its principal executive offices located in Palo Alto, California. HP recently merged with Compaq Computer Corporation ("Compaq") to create the world's second largest information technology company. HP is a leading global provider of business and home products in its four major business segments: Imaging and Printing Systems, Personal Systems, Enterprise Systems, and Information Technology Services. HP is the world's largest provider of imaging and printing systems, supplying products that include printers, printing supplies, printing presses, scanners, and digital cameras. HP Personal Systems products include commercial and home personal computers ("PCs") and personal digital assistants ("PDAs"). HP Enterprise Systems products include UNIX servers, PC servers, business critical computing systems, network storage devices, and related software solutions. The Information Technology Services business segment provides leading customer support, consulting, outsourcing and other services that allow customers to take advantage of emerging technologies and business models. The markets for each of HP's four principal business segments are characterized by short product life cycles and require the vigorous development of new and enhanced products and services. Hewlett-Packard Laboratories ("HP Labs"), together with the R&D efforts within the four principal business segments, conduct R&D to provide a continuing flow of innovative, high-quality products and services and to enhance current product offerings. HP's (including Compaq) expenditures for R&D in fiscal 2001 totaled $4 billion. HP's research, product development, and manufacturing are conducted in the United States and in numerous locations throughout the

world. HP maintains operations in more than 120 countries worldwide and sells products and services into additional locations through various representatives and distributors.

Intel Corporation ("Intel") is incorporated in the State of Delaware, with its principal executive offices located in Santa Clara, California. Intel supplies the basic building blocks and ingredients of computer architecture and the internet economy. Intel is the world's largest semiconductor chip maker, and its products include microprocessors, which control the central processing of data in personal computers, servers, workstations, and other devices; chipsets, which perform essential logic functions surrounding the central processing units in computers based on Intel architecture processors; and embedded control chips for automobile engines and braking systems, hard disk drives, cellular phones, and laser printers. Intel's competitive position has developed in large measure because of its emphasis on R&D activities. In 2001, Intel's R&D expenditures totaled $3.796 billion, and were devoted to the development of new products, as well as the enhancement of existing products. Intel's products are produced in the United States and in numerous locations abroad, and are sold for use in countries throughout the world.

KLA-Tencor Corporation ("KLA-Tencor") is incorporated in the State of Delaware, with its principal executive offices located in San Jose, California. KLA-Tencor was formed in April 1997 through the merger of KLA Instruments Corporation and Tencor Instruments, two long-time participants in the semiconductor equipment industry. KLA-Tencor is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. KLA-Tencor sells a broad spectrum of semiconductor equipment products designed to assist integrated circuit

manufacturers manage yield throughout the wafer fabrication process from the research and development phase to final mass production yield analysis. The markets served by KLA-Tencor are characterized by rapid technological development and product innovation. Accordingly, KLA-Tencor devotes a significant portion of its human and financial resources to R&D programs, and is committed to significant engineering efforts toward product improvement and new product development. The company's global customer base includes virtually every major semiconductor manufacturer in the world, and its products are sold throughout the United States, Europe, Asia-Pacific, and Japan.

Lexmark International, Inc. ("Lexmark") is incorporated in the State of Delaware, with its principal executive offices located in Lexington, Kentucky. Lexmark is a leading developer and manufacturer of printing solutions, including laser and inkjet printers for offices and homes, and a broad line of other office imaging products. Lexmark's products are sold in more than 150 countries in North and South America, Europe, Asia, and other locations throughout the world. In 2001, Lexmark's consolidated revenue totaled approximately $4.1 billion, and revenue derived from international sales comprised more than half of the total. Lexmark is a technology leader in its targeted areas and is actively engaged in the design and development of new products and enhancements of its existing products. Lexmark's process of developing new technology products is complex and requires innovative designs. In 2001, Lexmark's R&D expenditures were approximately $246 million.

Reebok International Ltd. ("Reebok") is incorporated in the Commonwealth of Massachusetts, and its principal executive offices are located in Canton, Massachusetts. Reebok is a global company, engaged primarily in the design

and marketing of sports and fitness products. Reebok is one of the world's leading companies engaged in the design, marketing, and distribution of sports, fitness, and casual footwear, apparel and equipment under the Reebok, Rockport, and Greg Norman brands, and footwear under the Polo Ralph Lauren brand. Reebok engages in product R&D and design activities at its product development facilities. R&D activities are integral to the company's success. Reebok places strong emphasis on technology and incorporates various proprietary performance technologies in its products. Reebok sells its products throughout the United States and in approximately 170 countries and territories worldwide. Reebok footwear and apparel products are distributed in the United States primarily through athletic retailers, sporting goods stores, and department stores. Reebok's sales outside the United States are conducted through its international distribution network, consisting of related entities and independent distributors around world.

United Technologies Corp. ("UTC") is incorporated in the State of Delaware, with its principal executive offices located in Hartford, Connecticut. UTC's operations are classified into four principal segments: Otis, Carrier, Pratt & Whitney, and Flight Systems. Otis is the world's largest elevator and escalator manufacturing and installation company. Carrier is the world's largest manufacturer of commercial and residential heating, ventilation, and air conditioning systems and equipment. Pratt & Whitney is among the world's leading suppliers of commercial, general aviation, and military aircraft engines. UTC's Flight Systems business includes Sikorsky Aircraft and Hamilton Sundstrand. Sikorsky Aircraft is one of the world's largest manufacturers of military and commercial helicopters.

Hamilton Sundstrand provides aerospace and industrial products and aftermarket services for a diverse group of industries worldwide. UTC's consolidated revenues in 2001 were approximately $28 billion, generated from sales in the United States and throughout the world. Technology can have a significant impact on UTC's operations and competitive position, and the company spends substantial amounts of its own funds on R&D. In 2001, those R&D expenditures were approximately 4.6 percent of total sales and totaled $1.254 billion.

On a cumulative basis, the *amici curiae* produce thousands of products in a wide variety of industries. Those products are sold in the United States and in markets throughout the world. Individually, each company conducts substantial R&D activities and is vitally interested in the tax incentives granted by Congress. The Ninth Circuit decision below seriously jeopardizes those incentives, and the *amici curiae* respectfully submit that it is essential for this Court to reverse that decision.

The *amici curiae* appear in this proceeding to enhance the Court's understanding of issues of vital interest to taxpayers across our country. Specifically, the Ninth Circuit decision frustrates and undermines policies of profound national interest: Encouragement of innovative R&D activities, and stimulation of exports from the United States.

STATEMENT

This proceeding involves an issue of fundamental importance involving R&D activities and the export tax incentives of the United States. Commencing in 1954, Congress provided tax incentives to encourage R&D efforts by United States businesses. *See, e.g.*, Internal Revenue

Code §§ 41, 174(a).[2] During the last sixty years, Congress has also enacted four separate tax regimes designed to stimulate and increase exports from the United States.[3] The taxable years at issue in the matter before the Court involve two of those export regimes, namely the Domestic International Sales Corporation ("DISC") provisions, and the Foreign Sales Corporation ("FSC") provisions.

The specific question presented in this proceeding concerns the application of a Treasury regulation[4] to the computation of export sales income under the DISC and FSC provisions of the Internal Revenue Code (26 U.S.C.).[5] In

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[2] References to sections of the Internal Revenue Code (26 U.S.C.) are to the Internal Revenue Codes of 1954 and 1986, as amended and in effect for the years at issue, unless otherwise stated.

[3] In 1942, Congress provided export tax incentives to "Western Hemisphere Trade Corporations." *See* Internal Revenue Code of 1939 § 109; Internal Revenue Code of 1954 §§ 921-922 (prior to repeal); S. Rep. No. 1631, 77th Cong., 2d Sess. 32, 111 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954). In 1971, Congress granted export tax incentives for "Domestic International Sales Corporations." *See* Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497. The "Foreign Sales Corporation" regime was enacted in 1984. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494. Most recently, export incentives were enacted in the Extraterritorial Income Exclusion Act of 2000. *See* Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

[4] References to sections of the regulations are to the Department of Treasury regulations, as published in 26 Code of Federal Regulations, and as in effect during the years at issue, unless otherwise stated.

[5] In the proceeding below, the parties agreed that for purposes of the issue in the present case there are no significant differences between the DISC and FSC regimes. *See* Pet. at 3, n.2; Pet. App. B. at 20a, n.2. References to "Pet." or "Pet. App." are to Petitioners' Petition For a Writ of Certiorari (and the Appendices thereto) in this proceeding (No. 01-1209). For convenience, the discussion herein is based solely on the DISC provisions, unless the context requires otherwise.

1994, the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of R&D expenses) was unreasonable and invalid when applied to the calculation of income under the DISC regime. *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394, 1396, 1402 (8th Cir. 1994). Seven years later, the court of appeals below reached the opposite conclusion on virtually identical facts.

Simply stated, the issue in this proceeding is whether, for purposes of calculating export benefits under the DISC regime, taxpayers must allocate R&D expenses to extremely broad product categories (such as "transportation equipment"), or whether taxpayers have an undeniable right to allocate R&D expenses to the more narrow product groups to which the expenses "directly relate." The Ninth Circuit below held that R&D expenses which were specific to particular products must be allocated to products sold for export, *even though those R&D expenses did not directly relate to the export products.* Conversely, the Eighth Circuit held the Treasury regulations provide taxpayers a right to choose recognized product or product line groups and to allocate R&D expenses to those specific product groups. *See St. Jude Medical,* 34 F.3d at 1396.

Under the DISC tax incentive regime, Congress allowed taxpayers to select one of three pricing methods to compute the maximum tax benefit from export activities. *See* I.R.C. § 994(a). The particular pricing approach at issue in this proceeding is the "combined taxable income" method ("CTI"), which is a net income concept calculated by determining gross export sales receipts and subtracting costs (including R&D costs) from those receipts. *See* I.R.C. § 994(b)(2).

The DISC legislative history provides that CTI is determined by deducting expenses "directly related" to the

production or sale of export property, and a portion of the expenses not allocable to "any specific item of income." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The Treasury regulations follow this legislative intent and provide that costs treated as relating to export gross receipts are those "definitely related" to the export sales, and a ratable part of other expenses not definitely related to a class of gross income, "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii).

For purposes of computing export income qualifying for the DISC incentive, the computations generally are made on a "transaction-by-transaction basis." Treas. Reg. § 1.994-1(c)(7)(i). As an alternative to transaction-by-transaction determinations, Congress intended to provide (and the regulations specifically grant) taxpayers the right to "group" transactions on the "basis of groups consisting of products or product lines." *See* H.R. Rep. No. 533, *supra*, at 74; Treas. Reg. § 1.994-1(c)(7)(i). The regulations further provide that the taxpayer's grouping choice "will be accepted" if it conforms with either (i) "recognized industry or trade usage," or (ii) "the two-digit major groups" of the Standard Industrial Classification ("SIC") manual, issued by the Office of Management and Budget. Treas. Reg § 1.994-1(c)(7)(ii). The Treasury regulations also provide that the taxpayer's grouping choice "shall be controlling," and costs "shall be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

These regulatory provisions establish basic principles in computing income subject to the DISC export incentives. First, a taxpayer is granted the right to "group transactions"

on the basis of specific "products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). Second, the taxpayer's grouping choice "will be accepted" if it conforms to a recognized industry or trade usage standard. Treas. Reg. § 1.994-1(c)(7)(ii). Assuming the choice conforms to such standard, the taxpayer's grouping "shall be controlling" and costs shall be allocated and apportioned to those groups. Treas. Reg. § 1.994-1(c)(6)(iv). Finally, costs "directly related" to those groups shall be allocated thereto, and costs directly related to specific products in non-export classes of income shall not be allocated to products generating export sales. *See* Treas. Reg. § 1.994-1(c)(6)(iii).

The Treasury regulation relating to the allocation or apportionment of R&D expenses (Treas. Reg. § 1.861-8(e)(3)) directly conflicts with the DISC legislative history and the DISC regulations. Under Treas. Reg. § 1.861-8 (e)(3), R&D expenses are allocated or apportioned to *all products* falling within broad two-digit categories, as enumerated in the SIC manual. Expenses are allocated to products in broad categories regardless of whether those expenses have any direct relationship to the products in the particular category. To the extent this regulation requires the allocation of R&D expenses that have no direct or definite factual relationship to specific products or product lines chosen by the taxpayer, the provision *is directly contrary* to the DISC statute, legislative history, and the DISC regulations. Consequently, as applied to such DISC determinations, Treas. Reg. § 1.861–8(e)(3) is unreasonable and invalid. *See St. Jude Medical*, 34 F.3d at 1396, 1402.

In this proceeding, Petitioners followed the applicable regulatory rules and chose to "group transactions" on the basis of specific product lines under recognized industry or trade usage, and not on the basis of the broad two-digit SIC

code category relating to "transportation equipment."[6] Despite the clear regulatory scheme, the Ninth Circuit found Petitioners were required to use the broad two-digit SIC code classification category, rather than the specific product lines selected by Petitioners pursuant to the right envisioned by Congress and granted under Treas. Reg. § 1.994-1(c)(7). Petitioners had an undeniable right to use the more specific product categories instead of the broad classifications imposed by the invalid Treasury regulation. *See St. Jude Medical,* 34 F.3d at 1396. *This right was intended by Congress for taxpayers across our country and was specifically granted by the Treasury regulations. See* H.R. Rep. No. 533, *supra*, at 74; Treas. Reg. § 1.994-1(c)(7)(i).

SUMMARY OF ARGUMENT

Congress enacted the R&D provisions of the Internal Revenue Code (26 U.S.C.) to encourage and promote innovative research and development efforts. Congress enacted the DISC and FSC provisions to stimulate activities resulting in the export of products from the United States. These incentives are of critical importance to companies throughout our nation.

The Ninth Circuit decision severely limits these incentives and undermines national policies encouraging R&D activities and granting export benefits. In a perverse way, the decision below increases the costs of companies conducting valuable R&D activities, thereby imposing financial penalties on those companies. The Ninth Circuit decision also dramatically diminishes the benefits of the export tax incentives promised by Congress, thereby directly impeding Congress's goal of increasing exports.

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[6] There is no disagreement that each of the product lines selected by Petitioners "constituted a separate product or product line under industry practice and trade usage." *See* Pet. App. A, at 2a; Pet. App. B, at 16a.

The decision by the court of appeals in this proceeding leads to negative practical consequences. The Ninth Circuit decision increases the costs of conducting innovative activity, severely limits the financial incentives enacted by Congress to operate manufacturing plants in the United States (leading to a potential loss of employment in our country), increases our trade deficit dilemma, and places United States companies at a global competitive disadvantage *vis-à-vis* companies located abroad. The decision by the court of appeals in this case should be reversed.

ARGUMENT

THE NINTH CIRCUIT DECISION UNDERMINES VITALLY IMPORTANT NATIONAL POLICIES

The decision below by the Ninth Circuit Court of Appeals is wrong as a matter of law. It is based solely on the application of an invalid Treasury regulation (Treas. Reg. § 1.861-8(e)(3)) to DISC determinations. *St. Jude Medical*, 34 F. 3d at 1396, 1402. The applicable statutory provisions, the relevant legislative history, and the controlling Treasury regulations, all support Petitioners' position and reversal of the decision below.

Equally important, the Ninth Circuit decision must be reversed because it is directly contrary to policies of vital national interest. Quite simply, the Ninth Circuit's analysis of the controlling authorities is strained and flawed because it is wholly inconsistent with the national interests reflected in those authorities, and directly conflicts with policies of immense importance to taxpayers throughout the United States.

The decision by the court of appeals below raises a fundamental question relating to the encouragement of R&D

activities and United States international trade policy. For many decades, the tax laws of our country have reflected national policies encouraging R&D efforts and stimulating export activities. The Ninth Circuit decision undermines those national policies by increasing the costs of conducting critical R&D activities and significantly diluting vital export incentives.

The relevant provisions of the Internal Revenue Code (26 U.S.C.) relating to R&D activities were enacted to encourage companies to engage in innovative research efforts. *See* Ways and Means Committee Rept., H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28, 57 (1954). The DISC provisions were enacted to provide incentives for United States companies to increase their exports to other countries. *See* H.R. Rep. No. 533, *supra*, at 58. The decision below jeopardizes these essential national policies enacted to ensure United States companies are able to compete on a fair and balanced level in the world trade arena.

I. The Decision Below Frustrates Policies Designed to Encourage R&D Activities.

Research, development, and experimentation efforts constitute the innovative forces necessary for the development of new products and technologies and for maintaining and enhancing existing products. R&D efforts are critical activities that must precede the development and manufacture of new products, the application to production of new techniques and equipment, and the enhancement of existing technologies. These activities are essential to the growth and expansion of businesses in our country and the development of our economy. Congress has long recognized the important role of R&D efforts in the United States and has enacted laws designed to promote those activities.

A. National Policies Encouraging R&D Efforts.

National policies have existed for at least forty-eight years providing tax benefits to encourage taxpayers to carry on R&D activities. Prior to 1954, no specific treatment was authorized under the Internal Revenue Code for R&D expenses. Such expenditures were deductible to the extent they constituted ordinary and necessary expenses incurred in a trade or business. To the extent R&D expenditures were capital in nature, they were capitalized or amortized over the useful life of the item. Where the useful life could not be definitely determined, taxpayers had no ability to amortize the R&D expenses. *See* H.R. Rep. No. 1337, *supra*, at 28; S. Rep. No. 1622, 83d Cong., 2nd Sess. 33 (1954).

In 1954, Congress enacted a special provision in the Internal Revenue Code granting taxpayers an election to deduct currently R&D expenditures. *See* I.R.C. § 174(a). Under section 174, a taxpayer may elect to deduct R&D expenses paid or incurred during the taxable year (*see* I.R.C. § 174(a)), or treat such expenditures as deferred expenses that can be amortized over a period of not less than 60 months. *See* I.R.C. § 174(b)(1). This election was granted to "encourage taxpayers to carry on" R&D activities. *See* H.R. Rep. No. 1337, *supra*, at 28; S. Rep. No. 1622, *supra*, at 33; *Snow v. Commissioner*, 416 U.S. 500, 504 (1974).

In 1981, Congress expressed concern over our nation's decline in R&D activities. Congress noted that, relative to real gross national product, R&D expenditures had significantly declined in a recent 12-year period, and aggregate R&D spending in the United States had experienced a similar period of decline. *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, H.R. 4242, 97th Cong., 1st

Sess. 119 (1981). Congress concluded that "spending for these purposes had not been adequate." *Id.*

To reverse the decline in R&D spending, Congress decided that a substantial tax credit for incremental R&D expenditures was needed "to overcome the reluctance" by many companies to bear costs needed to "initiate or expand research programs." *Id.* at 120. Congress noted that many businesses had been "reluctant to allocate scarce investment funds for uncertain rewards." *Id.* In response, Congress enacted a new provision of the Internal Revenue Code (currently, I.R.C. § 41) allowing an income tax credit for certain qualified research expenditures incurred by a taxp er in carrying on a trade or business.[7] The purpose of the credit was to "encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 904 (1984).

Congress believed that the new R&D tax credit would "stimulate a higher rate of capital formation and increased productivity" and would provide "incentives for greater private activity in research by operating businesses." *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, *supra*, at 120. The R&D credit was designed to assist companies in overcoming the reluctance "to bear the significant costs of staffing and supplies, and equipment expenses * * * which must be incurred to initiate or expand research programs in a trade or business." *Id.*

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[7] The R&D credit was originally enacted as I.R.C. § 44F, but was subsequently renumbered as I.R.C. § 30 (*see* Tax Reform Act of 1984, Pub. L. 98-369), and most recently as I.R.C. § 41 (*see* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085).

At the time the R&D tax credit was enacted in 1981, an expiration date for the credit "was deemed desirable * * * to enable Congress to evaluate the experience with the credit and its operation, and to determine whether it should be extended * * *." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, *supra*, at 904. Reflecting the critical importance of the R&D tax credit, Congress subsequently extended the expiration date of the credit on 10 separate occasions during the period from 1986 through 1999.[8] Currently the R&D credit is extended through June 30, 2004.[9]

This history of continuous legislative action reflects strong national policies which have existed for almost fifty years, from the original enactment of the election to deduct R&D expenses in 1954 (I.R.C. § 174(a)) through the repeated extensions of the effective date of the R&D tax credit (I.R.C. § 41). These national policies are specifically intended to encourage United States taxpayers to engage in R&D activities designed to enhance existing products and create new products and technologies. *See* H.R. Rep. No. 1337, *supra,* at 28; S. Prt. No. 169, *supra*, at 904.

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[8] *See* The Tax Reform Act of 1986, Pub. L. No. 99-514, § 231(a); The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110; The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, § 11402(a); The Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686, § 102(a); The Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13111; The Small Business Job Protection Act of 1986, Pub. L. No. 104-188, § 1204(a); The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 601; The Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, § 1001; The Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 1001.

[9] The Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 1001.

B. <u>The Ninth Circuit Decision Undermines Congress's Efforts to Encourage R&D Activities</u>.

The R&D incentives in the Internal Revenue Code (26 U.S.C.) have encouraged the development of many existing and new innovative products and industries. Each of the *amici curiae* engages in significant R&D activities in its respective markets. Those activities are vitally important to the world class positions the *amici curiae* have attained in their industries. The Ninth Circuit decision below frustrates this key national policy encouraging R&D efforts because it increases the financial cost for companies engaging in R&D activities that yield products sold only in the domestic market, unsuccessful products, or products *otherwise unrelated to export income.*

Under the provisions of the DISC regime, the greater the DISC export profit, the larger the amount of the taxpayer's tax-deferred income and the resulting benefits intended by Congress. *See St. Jude Medical*, 34 F.3d at 1397. The Ninth Circuit decision significantly diminishes these benefits because every dollar of R&D expenditures *unrelated* to export receipts creates a financial disadvantage for companies to the extent those R&D expenses are allocated or apportioned to products sold for export under the DISC provisions (thereby reducing the company's tax-favored DISC export profit). Assuming a set of products in the same broad SIC code category, the rule adopted by the Ninth Circuit means that R&D expenses directly related to *unsuccessful products not brought to market* nevertheless must be allocated or apportioned to current export income under the DISC provisions. Further, R&D expenditures directly related to products sold *only in the domestic market* must also be allocated or apportioned to products sold for export.

Under the reasoning of the court below, every dollar of these R&D expenses *reduces* the tax-benefitted export profits and the tax incentives enacted by Congress. This rule applies even though the R&D expenses *are not factually related* to the taxpayer's export products. In essence, the court of appeals decision increases the cost of performing certain R&D efforts and imposes a financial cost on companies engaging in these R&D activities. Companies are actually penalized for engaging in R&D efforts *unrelated* to export activities and export income, such as R&D activities generating products sold in the domestic market or unsuccessful products that never reach the market. Such an aberrational result should not stand.

The practical effect of the decision below also creates serious inequities among different companies manufacturing products for export. For companies operating in industries that experience high failure rates in their R&D activities (that is, large numbers of unsuccessful products are produced), the Ninth Circuit decision unnecessarily penalizes these companies compared to other industries because the decision requires the allocation of expenses from those R&D efforts to successful products sold for export. Congress did not intend such an illogical result.

The Ninth Circuit decision imposes a significant financial cost on companies engaging in critical R&D activities, and runs directly counter to historically important policies reflected in legislation enacted by Congress for almost fifty years. The decision below undermines one of our nation's most fundamental policies: The encouragement of broad-based R&D activities to create innovative products and to enhance existing products and technologies. The detrimental impact of the decision below on this key national policy warrants reversal by this Court.

II. THE NINTH CIRCUIT DECISION IMPOSES FINANCIAL DISINCENTIVES ON EXPORT ACTIVITIES.

A. The Historical Importance of Export Incentives.

Congress has been vitally interested in promoting exports through special incentives in the Internal Revenue Code for more than sixty years. [10] One of the earliest export tax incentive regimes was enacted in 1942 for Western Hemisphere trade corporations ("WHTCs"). The WHTC regime was enacted to "alleviate * * * competitive inequality." S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942). Until 1980, WHTCs enjoyed a fourteen percentage point reduction in the normal corporate tax rate related to exports and business activities conducted in the Western Hemisphere. I.R.C. §§ 921-922 (1954).

Commencing in the early 1970's, Congress enacted the first of three successive and interrelated regimes specifically designed to stimulate the manufacture of products for export from the United States. In 1971, Congress granted special tax benefits to DISCs to encourage the export of goods manufactured in the United States, and to equalize the taxation of United States companies with the European territorial system. *See* Pub. L. No. 92-178 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). Congress noted that the DISC regime was enacted to provide a "stimulative effect" for increased exports and to counterbalance other major trading nations that "encourage foreign trade by their domestic producers in one form or another." S. Rep. No. 437, *supra*, at 90.

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[10] *See* note 3, *supra*.

The DISC regime gave rise to complaints from other countries on the basis that it was an export subsidy in violation of the General Agreement on Tariffs and Trade. In 1984, Congress responded to these complaints by replacing the DISC rules with the closely related FSC provisions. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494.

Enactment of the FSC provisions did not deter attacks by other countries on our international trade policies, and in 2000 the World Trade Organization ("WTO") found that the FSC provisions were a prohibited export subsidy. In November 2000, Congress responded by repealing the FSC provisions and enacting a new provision referred to as the extraterritorial income exclusion ("ETI"). *See* Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000). The European Union filed a new complaint against the ETI provisions and in August 2001 a WTO panel held the new provisions also constituted a prohibited export subsidy.[11] Subsequently, in January 2002, an appellate body of the WTO modified and affirmed the panel's findings.[12] Because of the historic importance of these export tax regimes (DISC, FSC, and ETI), Congress is now considering various alternatives for resolving the WTO dispute while continuing to provide export incentives so that United States businesses can compete on a fair and level playing field with companies based abroad.[13]

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[11] United States--Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

[12] *Id.*, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002.

[13] *See* Hearings Before the House Committee on Ways and Means on the WTO's Extraterritorial Income Decision (February 27, 2002). It is

B. Policy Objectives of Encouraging Export Activities.

This long history of disputes relating to United States exports, international trade policies, and successive enactments by Congress of export incentives evidence vital national policies. It is in our national interest to encourage the export of products from the United States. Export activities create domestic jobs, facilitate capital investment, encourage construction of plants in our country, improve our balance of payments position, favorably impact interest rates, and support the value of the United States dollar in markets throughout world. Congress has recognized the importance of these national objectives and has sought to provide export incentives to United States businesses continually over the last sixty years.

Congress specifically enacted the DISC statute in 1971 to provide tax incentives to increase exports of products produced in the United States and in response to incentives provided by other major trading nations fostering foreign trade and encouraging exports by their domestic producers. *See* S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971); *Caterpillar Tractor Co. v. U.S.*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The FSC and ETI regimes continue this congressional policy of providing incentives to stimulate export activities.

In enacting the DISC provisions, Congress provided taxpayers incentives to "maximize DISC profit." *See St. Jude Medical*, 34 F.3d at 1397. In computing the maximum

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anticipated that the regulations interpreting the ETI provisions, as well as any subsequent legislation, will also present the issue in this proceeding. Consequently, this issue has continuing importance and relevance from the original DISC legislation, through the FSC and ETI provisions, and the anticipated future legislation in this area.

DISC benefit, Congress intended that "directly related" expenses should be allocated to export income. H.R. Rep. No. 533, *supra,* at 74. Congress further intended to grant taxpayers the right to choose groupings by specific product or product lines, and to allocate expenses directly related to those products or product lines. *See* H.R. Rep. No. 533, *supra*, at 74. The Treasury regulations reflect these basic principles (Treas. Reg. §§ 1.994-1(c)(6)(iii), 1.994-1(c)(7)(i)), and this right to group transactions has been codified in subsequent export legislation.[14]

It is in our country's national interest to encourage the development of domestic production facilities and thereby increase employment in the United States. Our national interests are served by reducing our trade deficit, strengthening the value of our currency abroad, and lowering our interest rates. Export incentives are critical factors in achieving these goals. Congress has acknowledged and supported these important national interests through the enactment of legislation designed to stimulate export activities. The Ninth Circuit decision ignores these critical objectives and our national interests.

C. The Decision Below Frustrates Congressionally-Mandated Export Incentives.

Contrary to the legislative intent and regulatory scheme underlying the DISC regime, the Ninth Circuit decision requires taxpayers to allocate R&D expenses to all products in broad SIC code product categories (rather than the specific product groupings selected pursuant to the right granted by Congress and reflected in the Treasury regulations). The approach of the court below requires the allocation of R&D expenses which are specific to particular products to *entirely*

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[14] I.R.C. § 927(d)(2)(B) (1984) (FSC regime), I.R.C. § 943(b)(1)(B) (2000) (ETI regime).

unrelated products sold for export, thereby diluting the incentives enacted by Congress. Quite simply, Congress never intended to significantly reduce the benefits under the export legislation by requiring *unrelated* R&D expenses to be allocated to sales of export products.

Indeed, in an effort to minimize the reduction of the benefits from these incentives, Congress provided exporters the right to "group transactions" on a product or product line basis. Subsequent legislation and the Treasury regulations have reinforced this intent by codifying the right to group transactions on a product or product line basis. *See* I.R.C. § 927(d)(2)(B) (1984) (FSC regime); I.R.C. § 943(b)(1)(B) (2000) (ETI regime); Treas. Reg. § 1.994-1(c)(7)(i). As a result, the court of appeals decision below is contrary to the congressional intent behind the DISC provisions and frustrates key national policies designed to encourage and increase exports.

The court of appeals decision below also leads to negative practical consequences. The DISC regime was enacted to encourage production of export products in the United States, rather than supplying products to customers from overseas locations. *See* H.R. Rep. No. 533, *supra*, at 58. The Ninth Circuit decision reduces the financial advantages of producing products in the United States. Movement of production capacity overseas leads to plant closures and the loss of jobs in United States. Reduction in exports exacerbates our foreign trade deficit, and negatively impacts interest rates in our country and the value of the United States dollar abroad. *In an economic environment where our nation is struggling to emerge from its first recession in a decade, these are critical practical considerations that emerge from the decision below and justify reversal by this Court.*

* * * * *

The essence of this proceeding is a conflict of overwhelming importance to companies across our nation engaged in R&D efforts and the production of products for export. This proceeding will determine whether vital national policies encouraging R&D activities and stimulating exports from the United States will be frustrated by the Ninth Circuit decision. This Court should not allow such an irrational result.

CONCLUSION

The decision below by the United States Court of Appeals for the Ninth Circuit should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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IN THE
Supreme Court of the United States

No. 01-1209

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioners, the Boeing Company and its subsidiaries.[1] Tax Executives Institute ("TEI" or "the Institute") is a voluntary, nonprofit association

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, its members' companies, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioners and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and has approximately 5,300 members who represent more than 2,800 of the leading businesses in the United States, Canada, and Europe. The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers.

Members of the Institute have a vital interest in this case, which involves the resolution of a sharp conflict concerning the interpretation of tax statutes affecting the foreign commerce of the United States. The substantive issue in the case is whether Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of research and development expenses) is valid when its application frustrates the operation of the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code. Eight years ago, the U.S. Court of Appeals for the Eighth Circuit held in *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394 (1994), that the Treasury Regulation is invalid in this context, noting that the mandated allocation method is inconsistent with Congress's intent to allocate costs to definitely related gross receipts. In the instant case, the U.S. Court of Appeals for the Ninth Circuit declined to follow *St. Jude Medical* and held instead that the regulation is valid. *Amicus* TEI submits that the Ninth Circuit's decision is wrong because it misapprehends the DISC and FSC statutory schemes and permits Treas. Reg. § 1.861-8(e)(3) not only to override the statute but also to undermine congressional intent.

This case has significant ramifications for taxpayers other than Boeing. The resolution of the question presented in this

case affects the tax liabilities of thousands of other businesses that are also subject to these provisions. As individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

1. For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets. Because of the similarity between the provisions, *amicus* TEI will focus primarily on the rules applicable to DISCs.

This case involves how Boeing's research and development (R&D) expenses should be allocated to the revenues generated by its export sales of commercial aircraft for purposes of determining its allowable benefits under the DISC and FSC provisions. The issue arises because Treas. Reg. § 1.861-8(e)(3) *requires* taxpayers to allocate R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget. The DISC regulations, however, allow taxpayers greater flexibility, permitting them to group transactions along product lines.

In determining its combined taxable income (CTI) during 1979 through 1987, Boeing exercised its right to elect product groupings under the DISC and FSC regulations, grouped its export sales by airplane program, and determined its costs, including R&D costs, for each airplane program. Under the DISC regulations, Boeing's determination properly allocated definitely related expenses to its export sales and was also consistent with the general rule of Treas. Reg. § 1.861-8(a)(2), which provides that "allocations and apportionments are made on the basis of the factual relationship of deductions to gross income."

The government disagreed with Boeing's approach, not on the grounds that it had failed to establish a direct link to support its allocation, but rather on the grounds that Treas. Reg. § 1.861-8(e)(3) applies certain mechanical rules for allocating R&D expenses. Although the district court held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation, the Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." App. at 2a.[2] The court's conclusion is wrong as a matter of law.

Amicus TEI submits that Treas Reg. § 1.861-8(e)(3)'s requirement that a taxpayer allocate R&D expenses to sales revenues within a single two-digit SIC code vitiates the flexibility taxpayers have under the DISC statute to claim congressionally provided tax benefits. The section 861 regulations were tailored for the purpose of allocating and apportioning income and expenses between foreign and domestic sources under the foreign tax credit provisions of the Code. The mechanical rules of Treas. Reg. § 1.861-8(e)(3) impermissibly conflict with the more specific DISC regulations, which accord taxpayers a choice in grouping sales according to product lines. Because Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the purposes of the DISC provisions, it is invalid as applied to DISCs.

2. Congress enacted the DISC and FSC provisions to provide a more level playing field for U.S. companies competing in foreign markets. The DISC provisions were enacted at a time when the economy was doing poorly. The Nixon Administration determined that tax changes were needed as part of a balanced program of stimulation and

[2] References to "App." are to the appendix filed with Boeing's Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, No. 01-1209 (Feb. 15, 2002).

stability. The changes were designed not only to stimulate spending but also to provide more jobs in the United States. Congress agreed, stressing the importance of providing tax incentives for U.S. firms to increase their international business not only because of their stimulative effect, but also to remove a disadvantage to U.S. businesses engaged in export activities through domestic subsidiaries. The Revenue Act of 1971 contained the DISC provisions, which were intended to provide a broad incentive program for taxpayers.

In establishing the DISC regime, Congress created a statutory scheme that was clearly intended to permit DISCs to earn profits in excess of those earned under the arm's-length pricing rules otherwise used between related parties. Thus, Congress established a unique regime under which taxpayers using DISCs were to obtain benefits not ordinarily then available.

3. There are two primary reasons why Treas. Reg. § 1.861-8(e)(3) should not be applied to the calculation of CTI. First, Congress intended only that the *general* principles of section 861 should apply in the DISC context. Second, the special allocation rule of Treas. Reg. § 1.861-8(e)(3) does not further those principles in this context.

A. Computing CTI requires allocating costs to gross receipts and, in the first instance, requires allocating costs to the gross receipts to which they definitely relate. If costs are not definitely related to certain receipts, they are apportioned among income on a ratable basis. Congress provided that these allocations and apportionments are to be "*determined in a manner consistent with* the rules set forth in § 1.861-8." The DISC regulation—Treas. Reg. § 1.994-1(c)(6)(iii)—implements this legislative history by providing that CTI should be determined "*generally in accordance with the principles applicable under section 861*."

What is abundantly clear is that the regulation implementing the DISC provisions and governing the allocation of costs for CTI purposes, as well as the legislative history of the DISC provisions, express respect for the section 861 principles, but go no further. The DISC rules contemplate "consistency." The legislative history contemplates applying generally the "principles" of section 861. In each case, the goal of the statute is to determine CTI so that actual circumstances are reflected. The government's attempt to rigidly apply rules crafted under section 861 for another purpose is unsupportable and distortive.

The Code's sourcing rules "undertake to classify the sources of income within the United States by the nature and location of the activities of the taxpayer or his property which produces income." *Commissioner v. Ferro-Enamel Corp.*, 134 F.2d 564, 566 (6th Cir. 1943). The rules have been a part of the tax law almost since the beginning of the modern income tax. Treas. Reg. § 1.861-8 provides some general and some mechanical guidance for allocating and apportioning deductions. From a general perspective—consistent with the DISC regulations—there must be a factual relationship between the deduction and the class of gross income. Treas. Reg. §§ 1.861-8(a)(2),-8(b)(2). If a deduction cannot be identified with any specific class of gross income, it will generally be apportioned among all of the taxpayer's gross income under Treas. Reg. § 1.861-8(b)(5). Boeing's allocations were consistent with these general rules.

That the DISC legislative history and regulations incorporate consistency with the general section 861 principles into the CTI calculation does not mean that the statute requires the mechanical application of Treas. Reg. § 1.861-8(e)(3) or provides support for its validity in these circumstances. "Consistent" means "compatible"; it does not mean "identical." *See Webster's Ninth New Collegiate Dictionary* 280 (1988). Indeed, it would be serendipitous if

the rules crafted for determining income source could be applied, without modification, to implement the DISC regime with equally important but different policy objectives.

In this case, the cross-references to the principles of section 861 in the DISC regulation and legislative history are not authority to apply all the mechanical rules of the section 861 regulations for purposes of allocating costs, without regard to factual relationships, to sales in determining CTI. The objective of the DISC statute—to allocate costs in accordance with some factual relationship—may not be foreclosed, as the government would do in this case.

B. Under the general section 861 rules, a factual relationship between income and expense is a key element of allocation and apportionment. These are the "principles applicable under section 861" to which Congress referred in 1971 and which the DISC statute contemplates will be applied in determining CTI—a factual connection between income and expense is clearly required.

In contrast, the special rules for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3) are mechanical rules that apply *in lieu of the general section 861 principles* in allocating R&D expenses. Rather than identifying a class of income to which the R&D expenditures actually relate, Treas. Reg. § 1.861-8(e)(3) generally assigns the expenditures to income related to a broad product category, which is limited to a list determined by two-digit SIC codes. The special allocation of R&D expenses may be appropriate in the context of the computation of the foreign tax credit, but it clearly undermines congressional intent in respect of the computation of CTI. Indeed, the consistency contemplated by Congress and Treas. Reg. § 1.994-1(c)(6)(iii) comes only by applying the general rules of the regulations under section 861 to establish definite factual relationships, not by departing from those relationships by applying mechanical rules for allocating R&D expenses.

It is consistent with the section 861 principles for the allocation of R&D expenses to yield to the DISC and FSC rules. By mandating the use of a special allocation rule for R&D expenses in respect of DISCs, the Treasury Department does violence to the statutory scheme. Treas. Reg. § 1.861-8(e)(3) is invalid as applied by the government to the computation of CTI.

ARGUMENT

I. THE NINTH CIRCUIT'S DECISION IS WRONG AS A MATTER OF LAW.

For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets.[3] In 1971, deficits in the United States' balance of trade led to the enactment of the DISC provisions. *See* Revenue Act of 1971, § 501, Pub. L. No. 92-178, 85 Stat. 497 (1971); *L&F Int'l Sales Corp. v. United States*, 912 F.2d 377, 377 (9th Cir. 1990).[4] Following a challenge under the General Agreement on Tariffs and Trade, Congress replaced the regime in 1984 with the FSC provisions. Deficit Reduction Act of 1984, § 801(a), Pub. L. No. 98-369, 98 Stat.

[3] Unless otherwise noted, references to the "Code" or "I.R.C." are to the Internal Revenue Code of 1954 and 1986 (26 U.S.C.), in effect during the years at issue in this case.

[4] A corporation qualifying as a DISC is permitted to earn a commission or profit on export sales that is not subject to immediate taxation. The DISC's parent corporation is taxed on a specified portion of the DISC income as a "deemed" distribution; the remaining income is tax-deferred until distributed to the parent or the corporation ceases to qualify as a DISC. The size of commission (or amount of profit) that the DISC may earn is determined according to one of three pricing methods provided by statute. I.R.C. §§ 991-97.

494 (1984).[5] Although there are technical differences between the two statutes, the FSC provisions retain many features in common with the predecessor DISC statute, including the features at issue here; the principal objective of these provisions is to address the inequities that arise when U.S.-based companies compete in foreign markets because of fundamental differences between the U.S. system of taxation and those of many other countries. The legislation provides a more level playing field for these companies. For more than 30 years, these provisions have served their purpose.

The issue in this case involves how Boeing's research and development (R&D) expenses should be allocated to the revenues generated by its export sales of commercial aircraft for purposes of determining its income from those sales and consequently its allowable benefits under the DISC and FSC provisions of the Internal Revenue Code.[6]

To determine taxpayers' maximum DISC benefit, Congress provided three methods for allocating the income:

> In the case of a sale of export property to a DISC by a [related] person . . . , the taxable income of such DISC

[5] A FSC is generally not subject to taxation on its "exempt foreign trade income," which is treated as foreign source income not effectively connected with the conduct of a U.S. trade or business. Again, the benefit is determined according to one of three alternative pricing methods. I.R.C. §§ 921-27. After the enactment of the FSC provisions, a modified version of the DISC statute remained in effect. I.R.C. § 995. In 2000, because of a trade dispute over the validity of the FSC regime, Congress repealed the FSC provisions and enacted the extraterritorial income (ETI) provisions. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000), *codified at* I.R.C. §§ 114, 941-43.

[6] Given the reliance of the FSC regulations on their predecessor DISC rules, this brief follows the lead of the Ninth Circuit in discussing primarily the DISC provisions of the Code. App. at 6a n.3. *See also* Stip. ¶ 28 ("Although there are some differences between the DISC and FSC rules, none of them relate to th[e] issue in this case.").

and such [related] person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (*regardless of the sales price actually charged*) in an amount which does not exceed the *greatest* of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

I.R.C.§ 994(a) (emphasis added); *see* App. at 27a. The taxpayer may "choose the method resulting in the greatest amount of profit." *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394, 1397 (8th Cir. 1994).

Pursuant to the latitude provided by Congress, Boeing elected to use the combined taxable income (CTI) method for calculating the amount of benefit to which it was entitled under the DISC provisions. Treas. Reg. § 1.994-1(c)(6) defines CTI as the excess of the DISC's gross receipts from the sale of export property over the total costs of the DISC and its supplier that relate to those gross receipts. In general, a higher CTI from a transaction will result in a larger benefit. In calculating CTI on export sales, revenues from sales must be determined as well as the costs and expenses properly allocable to those sales. Treas. Reg. § 1.994-1(c)(6)(iii) requires that a taxpayer allocate to revenues from export sales

"(a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto," and (b) a ratable part of any other expenses, losses, or other deductions "determined *in a manner consistent with* the rules set forth in [Treas. Reg.] § 1.861-8." (Emphasis added.) This regulation implements the statutory directive to compute CTI on export sales and mirrors the legislative history of the DISC provisions. That history states that income shall be determined "*generally in accordance with the principles* applicable under section 861." H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 74 (1971) (hereinafter cited as the "1971 House Report")(emphasis added); S. Rep. No. 92-437, 92d Cong., 1st Sess. 107 (1971) (hereinafter cited as the "1971 Senate Report") (emphasis added).

The DISC regulations specifically permit taxpayers to group their transactions. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis, but the taxpayer may annually elect to group the transactions according to product lines. The only limitation placed on the use of the administrative pricing methods is that the amount of taxable income that a supplier may shift to the DISC may not exceed 100 percent of the supplier's income generated by the transaction. Treas. Reg. § 1.994-1(e)(1)(i).

The issue in this case arises because Treas. Reg. § 1.861-8(e)(3)—which was added to the regulations after the enactment of the DISC provisions—*requires* taxpayers to mechanically allocate R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget. The DISC CTI calculation, however, contemplates allocating revenues from particular sales and, where grouping of products is elected, to particular products. In determining its CTI in this case, Boeing exercised its right to elect product groupings under the DISC regulations, grouped its export

sales by airplane program, and determined its costs, including R&D costs, for each airplane program. The company calculated its CTI on airplane sales net of the costs so determined. Under the DISC regulations, Boeing's determination properly allocated definitely related expenses to its export sales and was also consistent with the general rule of Treas. Reg. § 1.861-8(a)(2), which provides that "allocations and apportionments are made on the basis of the factual relationship of deductions to gross income."

The government disagreed with Boeing's approach, not on the grounds that it had failed to establish a direct link to support its allocations, but rather on the grounds that Treas. Reg. § 1.861-8(e)(3) requires that certain mechanical rules for allocating R&D expenses be directly applied to DISC. Application of those rules increased the R&D expenses allocable to Boeing's export sales, decreased CTI, and thereby reduced Boeing's DISC benefit.

In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical*, 34 F. 3d at 1401, which held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation. Finding the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case," the district court found that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the computation of CTI that were "fatal" to the validity of the regulation. App. at 18a-19a, 23a. On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. App. at 2a.

Amicus TEI submits that the requirement of Treas. Reg. § 1.861-8(e)(3) that a taxpayer must allocate R&D expenses to sales revenues within a single two-digit SIC code vitiates the flexibility taxpayers have under the DISC statute to maximize tax benefits. The section 861 regulations were tailored for the purpose of allocating and apportioning income

and expenses between foreign and domestic sources under the foreign tax credit provisions of the Code. When applied to CTI calculations, however, Treas. Reg. § 1.861-8(e)(3) conflicts with another statute of equal importance and fails to achieve the DISC statutory goal of determining CTI based on the factual relationships between revenues and costs. In this context, the mechanical rules of that regulation impermissibly conflict with the more specific DISC regulations, which allow taxpayers a choice in grouping sales according to product lines. Because Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the purposes of the DISC provisions, it is invalid as applied to DISCs.

II. THE DISC PROVISIONS WERE INTENDED TO PROVIDE A MORE LEVEL PLAYING FIELD.

Congress enacted the DISC and FSC provisions to provide a more level playing field for U.S. companies competing in foreign markets. The DISC provisions were enacted at a time when the economy was doing poorly. The United States was experiencing high unemployment, a low gross domestic product, little or no growth in capital goods expenditures, and a rising inflation rate. Wage and price controls had been imposed and there was growing concern about the trade imbalance between the United States and other countries. 1971 House Report at 1, 3-4; 1971 Senate Report at 1-2, 6. The Nixon Administration determined that tax changes were needed as part of a balanced program of stimulation and stability. The changes were designed not only to stimulate spending but also to provide more jobs in the United States. *See* The White House, *Explanatory Material on the President's Economic Program* (Aug. 15, 1971), *reprinted in* BNA SPECIAL REPORT, App. C at C-2 (Aug. 16, 1971). It was against this background that Congress enacted the Revenue Act of 1971.

In the Administration's view, the DISC measure would "provide a substantial stimulus to United States producers to increase their export sales with resulting favorable effects on our balance of payments. This will create additional jobs by strengthening the position of our companies in world markets." *Id.* at C-4. Congress agreed, stressing the importance of providing tax incentives for U.S. firms to increase their exports not only because of their stimulative effect, but also to remove a disadvantage to U.S. businesses engaged in export activities through domestic subsidiaries:

> United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether those earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.
>
> In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports. Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, [the House Ways and Means] committee's bill provides a deferral of tax where corporations meeting certain conditions—called Domestic International Sales Corporations—are used.

1971 House Report at 58; *see also* 1971 Senate Report at 90.

In enacting the DISC regime, Congress provided taxpayers with a broad incentive program. In order to maximize the benefit provided under the statute, Congress suspended several general rules of taxation that normally apply to taxpayers. Contrary to the treatment afforded other entities under the tax law, a DISC may be a corporation whose sole function is to serve as an accounting device for measuring the amount of export earnings subject to tax deferral. Treas. Reg. § 1.992-1(a). Congress also determined it desirable to avoid the complexities of the Internal Revenue Code's transfer pricing rules—which require a determination of an arm's-length price between related persons—and to adopt administrative rules for determining intercompany pricing. I.R.C. § 994. *See also* 1971 House Report at 73. These rules permitted the DISC to maximize its taxable income regardless of the sales price actually charged for the property. I.R.C. § 994(a).

The CTI method, used by Boeing in this case, is one of the two administrative pricing rules adopted by Congress in 1971. To further its intended effects, Congress created a statutory scheme that was clearly intended to permit DISCs to earn profits in excess of those earned under the arm's-length pricing rules otherwise used between related parties. 1971 House Report at 73-74; *see St. Jude Medical*, 34 F.3d at 1400. Thus, Congress established a unique regime under which taxpayers using DISCs were to obtain benefits not ordinarily then available.

III. TREAS. REG. § 1.861-8(e)(3) SHOULD NOT CONTROL THE CALCULATION OF CTI.

There are two primary reasons Treas. Reg. § 1.861-8(e)(3) should not govern the calculation of CTI. First, Congress intended only that the *general* principles of section 861 should apply in the DISC context. Second, the special allocation rule of Treas. Reg. § 1.861-8(e)(3) does not further those principles in this context.

A. Consistency with the Principles of Section 861 Does Not Lead to the Mechanical Application of the Special Allocation Rule in Treas. Reg. § 1.861-8(e)(3).

Computing CTI requires allocating costs to gross receipts and, in the first instance, requires allocating costs to the gross receipts to which they definitely relate. If costs are not definitely related to any receipts, they are apportioned on a ratable basis. Under Treas. Reg. § 1.994-1(c)(6)(iii), these allocations and apportionments are to be "determined in a manner consistent with the rules set forth in § 1.861-8." This regulation implements the legislative history providing that CTI should be determined "*generally in accordance with the principles applicable under section 861.*" The legislative history describes these principles, as follows: "These rules generally allocate to each item of gross income all expenses *directly related* thereto, and then apportion other expenses among all items of gross income on a ratable basis." 1971 House Report at 74; Senate Report at 107 (emphasis added). What is abundantly clear is that neither the regulation implementing the DISC provisions and governing the allocation of costs for CTI purposes nor the legislative history of the DISC provisions contemplates a mechanical application of rules later adopted under section 861 to the computation of CTI. These rules express respect for the principles of section 861, but they stop short of incorporating section 861 in its entirety into the DISC pricing rules. Treas. Reg. § 1.994-1(c)(6)(iii) contemplates "consistency." The legislative history contemplates applying generally the "principles" of section 861. In each case, the goal of the statute is to determine CTI based on definite relationships.

In defiance of this objective, the government insists that the mechanical rules of Treas. Reg. § 1.861-8(e)(3) be applied to allocate R&D expenses in determining CTI. This attempt at rigid application of rules crafted under section 861 for

another purpose is unsupportable and would cause distortion in the calculation of CTI. To understand this, a brief review of the background of the mechanical rules at issue may be helpful.

Section 861 of the Code contains the general sourcing rules for determining when income should be treated as earned within the United States. Coupled with sections 862 (source rules for income without the United States) and 863 (special rules for determining the source of income), these provisions "undertake to classify the sources of income within the United States by the nature and location of the activities of the taxpayer or his property which produces income." *Commissioner v. Ferro-Enamel Corp.*, 134 F.2d 564, 566 (6th Cir. 1943). Both sections 861(b) and 862(b) allow deductions for expenses, losses, and other deductions properly allocated and apportioned to the gross income items listed in sections 861(a) and 862(a), respectively, and allow deductions for a ratable part of expenses, losses, and other deductions not definitely allocable to some item of gross income.[7]

The sourcing rules have been a part of the tax law almost since the beginning of the modern income tax. The current statutory provisions trace their origins to the Revenue Act

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[7] In general, a taxpayer first determines aggregate gross income in accordance with section 61 and the relevant principles of the Code and then identifies its deductions. With respect to each deduction, the taxpayer must then identify ("allocate") the deduction with the category of gross income to which it relates. After deductions are allocated to a class, they are "apportioned" within that class between the statutory and the residual grouping of gross income. *See generally*, CYM H. LOWELL, G. MICHAEL TILTON, ANDREW W. SHELDRICK & MICHAEL J. DONOHUE, U.S. INTERNATIONAL TAXATION: AGREEMENTS, CHECKLISTS & COMMENTARY ¶ 7.03[2] (2002). If a deduction is related to all classes of gross income, it is generally allocated ratably. Treas. Reg. § 1.861-8(b)(5).

of 1921, Pub. L. No. 98, § 217, 42 Stat. 227 (1921).[8] The sourcing rules are important for a variety of reasons, but primarily relate to the computation of the foreign tax credit. A major policy premise underlying these rules is that the United States has the right to tax fully U.S.-source income but acknowledges the primary right of foreign countries to tax foreign-source income. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Cong., 1st Sess. 916 (1987).

Treas. Reg. § 1.861-8 provides some general and some specific, mechanical guidance for allocating and apportioning deductions. From a general perspective, in matching an expense, loss, or other deduction with an income class, there must be a factual relationship between that item and the class of gross income. Treas. Reg. §§ 1.861-8(a)(2), -8(b)(2). In this regard, the rules state that classes of gross income are not predetermined. Treas. Reg. § 1.861-8(b)(1). This is entirely consistent with the DISC rule for determining CTI. If a deduction cannot be identified with any specific class of gross income, it will generally be allocable to all of the taxpayer's gross income. Treas. Reg. § 1.861-8(b)(5). Boeing's allocations were consistent with these general rules.

The DISC legislative history and regulations incorporate consistency with the general section 861 principles into the CTI calculation. That such consistency is contemplated, however, does not mean that the statute requires the mechanical application of Treas. Reg. § 1.861-8(e)(3). In other words, "consistent" means "compatible"; it does not mean "identical." *See Webster's Ninth New Collegiate Dictionary* 280 (1988). Indeed, it would be serendipitous if the rules crafted for determining income source could be

[8] The first statute requiring the allocation of deductions to income from specified sources was the Revenue Act of 1918, §§ 214(b), 234(b), Pub. L. No. 254, 40 Stat. 1057 (1918).

applied, without modification, to implement the DISC regime with equally important but different policy objectives.[9]

This Court has cautioned about the ill effects of mechanically applying the terms of rules structured for one purpose to the interpretation of another statute with a vastly different objective. In this regard, *Bowen v. Michigan Academy of Family Physicians*, 476 U.S. 667 (1986), is instructive. There, the Court considered a challenge by physicians to the validity of a regulation under Part B of Medicare, which authorized the payment of benefits in different amounts for similar services. The Medicare statute cross-referenced provisions of the Social Security Act that prohibited certain actions against the government.[10] The Secretary of Health and Human Services contended that the cross-reference demonstrated that Congress had forbidden judicial review of all questions affecting the payment of benefits under Part B of Medicare. The Court held, however, that the legislative history of the Medicare program provided specific evidence of Congress's intent to foreclose review only of "amount determinations," not of substantial statutory and constitutional challenges to the Secretary's administration of Part B. Thus, the incorporation by reference to the Social Security Act restrictions did not apply on its own terms to Part B, but rather was incorporated *mutatis mutandis*, *i.e.*, all

[9] As this Court has noted, "The policy as well as the letter of the law is a guide to decision." *Cox v. Roth*, 348 U.S. 207, 209 (1955) (citation omitted). In *Cox*, the Court refused to permit a literal application of the Federal Employers' Liability Act (FELA) to result in the denial of recovery under the Jones Act against a personal representative of the owners of a vessel lost at sea. The Court found that the exact words of FELA should not be "lifted bodily from their context and applied mechanically to the specific facts of maritime events." *Id.*

[10] Section 405(h) of title 42 provided that "no action . . . to recover any claim" arising under the Medicare laws shall be "brought under section 1331 . . . of title 28."

necessary changes having been made, into the Medicare statute. *Id.* at 679.[11] A similar logic should apply to this case.

In this case, the reference to the principles of section 861 in the DISC regulation and legislative history is not license to apply all the mechanical rules of the section 861 regulations for purposes of allocating costs, without regard to factual relationships, to sales in determining CTI. The objective of the statute—to allocate costs in accordance with some factual relationship—may not be arbitrarily foreclosed, as the government would do in this case.

B. Treas. Reg. § 1.861-8(e)(3) Is a Radical Departure from the General Rules and Principles of Section 861.

Under the general section 861 rules, a factual relationship between income and expense is a key element of allocation and apportionment. *See* Treas. Reg. §§ 1.861-8(a)-(d). These are the "principles applicable under section 861" to which Congress referred in 1971 and which the DISC statute contemplates will be applied in determining CTI—a factual connection between income and expense is clearly required. *See* I.R.C. § 994(a)(2) (requiring determination of net income "attributable to" the export sale).[12] When Treas. Reg.

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[11] In *Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 17-18 (2000), the Court clarified that the reasoning of *Michigan Academy* applied only when the statute precluded *any* review of a particular category of cases.

[12] The legislative history of the provision confirms that "[t]hese rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis." 1971 House Report at 74 (emphasis added). CTI is determined by "deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are *directly related to the production or sale of the export property.*" *Id.* (emphasis added). Thus, expenses related to property that is not exported are not allocated to export sales of other property.

§ 1.994-1(c)(6)(iii) was adopted in 1975, the mechanical rules on which the government relies in this case did not exist. Indeed, they were not adopted until a couple years later in 1977.[13]

In contrast, the special rules for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3) are mechanical rules that apply *in lieu of the general section 861 principles* in allocating R&D expenses.[14] The government recognizes this in the regulation's first paragraph by confirming that the regulation is a substitute for the factual inquiry. Treas. Reg. § 1.861-8(e)(3)(i)(A) begins—

> The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development.[15]

Rather than identifying a class of income to which the R&D expenditures actually relate, the regulation generally assigns

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[13] This regulation was later repromulgated in 1995 as Treas. Reg. § 1.861-17.

[14] The proposed section 861 regulations in place at the time the DISC regulations were issued retained the factual relationship principle in respect of R&D expenses and did not require the use of SIC codes. 38 Fed.Reg. 15840, 15843 (June 18, 1973).

[15] The regulations also specifically presuppose that the mechanical rules are not intended to effect an allocation of deductions to all gross income but rather address allocations to specific classes of gross income. *See* Treas. Reg. § 1.861-8(b)(1).

the expenditures to income related to a broad product category, which is limited to a list determined by two-digit SIC codes.[16]

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[16] It is difficult to see how a system that classifies economic data by industrial categories can also serve the purposes of matching gross income from the sale of specific products with the specific costs that are directly related to them. The SIC Code system was replaced by the North American Industry Classification System (NAICS) in 1997 because it was considered outmoded:

> The SIC was established to promote uniformity and comparability of data collected and published by agencies within the U.S. government, state agencies, trade associations, and research organizations. It was developed as an establishment-based industry classification system that classified each establishment (defined as a single physical location at which economic activity occurs) according to its primary activity. The SIC covered the entire field of economic activities by defining industries in accordance with the composition and structure of the economy.

U.S. Census Bureau, *Development of NAICS*, *reprinted at* http://www.census.gov/epcd/www/naicsdev.htm. The system was designed to "classify 'industry' in the broad sense of all economic activity; *i.e.*, agriculture, forestry, and fisheries; mining; construction; manufacturing; wholesale and retail trade; finance, insurance, and real estate; transportation, communication, electric, gas, and sanitary services; and services." Esther Pearce, *History of the Standard Industrial Classification* (Executive Office of the President, Bureau of the Budget, Office of Statistical Standards, July 10, 1957), *reprinted at* http://www.census.gov/epcd/www/sichist.htm.

Requiring the use of even three-digit SIC codes (as currently required by Treas. Reg. § 1.861-17) can produce absurd results. For example, R&D expenses directly related to main frame computers would be allocated to pencil sharpener receipts because both pencil sharpeners and computers are in the same three-digit SIC Code (357—Computer and Office Equipment). Examples of other product groupings include canned tuna fish and freeze-dried coffee (SIC Code 209), perfumes and floor wax (SIC Code 284), and batteries and extension cords (SIC Code 369).

The special allocation of R&D expenses may be appropriate in the context of the computation of the foreign tax credit, but it undermines congressional intent in respect of the computation of CTI. As the Eighth Circuit determined in *St. Jude Medical*, Treas. Reg. § 1.861-8(e)(3)'s requirement to use SIC categories in allocating R&D expenses "is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted). "Doing so," the court stated, "may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules." *Id.* at 1402-03. In effect, the government's proposed application of the mechanical rules of section 861 to the allocation of R&D expenses for DISC purposes would preclude any allocation to transactions or products based on actual factual relationships.

Although the government approach is consistent with the mechanical rules of Treas. Reg. § 1.861-8(e)(3), it is inconsistent with (i) section 994(a)(2)'s requirement for determining net income "attributable to" the export sale; (ii) the general rules of the section 861 regulations as they exist today, (iii) all aspects of those regulations as they existed at the time that Treas. Reg. § 1.994-1(c)(6)(iii) was promulgated, (iv) the mandate of Treas. Reg. § 1.994-1(c)(6)(iii) that requires allocations of deductions based on definite factual relationships, and (v) the flexibility afforded taxpayers to permit DISC benefits to be calculated by reference to CTI determined on a product-by-product basis after allocating costs based on factual relationships. Indeed, the consistency contemplated by the statute and Treas. Reg. § 1.994-1(c)(6)(iii) comes only by applying the general rules of the regulations under section 861 to establish definite factual relationships, not by departing from those relationships by applying the mechanical rules for allocating R&D expenses. This is particularly true where taxpayers, because of the structure of their sales and manufacturing

production and the detailed records kept, can clearly establish the necessary factual relationships. In contrast to Treas. Reg. § 1.861-8(e)(3), the section 994 regulations are consistent with congressional intent because they permit taxpayers to allocate R&D costs to products and product groupings based on factual relationships.

It is enlightening that neither the Ninth Circuit nor the government seeks to justify the application of the mechanical R&D rule to allocations under section 994 on the ground that it achieved allocations based on factual relationships. Indeed, the Ninth Circuit seeks to justify the application of a rule that ignores factual relationships on the grounds that the deductions at issue might be considered unrelated to specific income items. *See* App. at 12a. But this analysis does not support the application of the rule at issue since that rule is not one that purports to allocate deductions ratably.[17]

It is consistent with "the principles applicable under the section 861" for the allocation of R&D expenses to yield to the DISC and FSC rules. *Cf. Rite Aid Corp. v. United States*,

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[17] That Boeing's R&D expenditures may have exceeded its income in a given product category in any year is irrelevant. The section 861 regulations clearly contemplate situations in which the costs directly related to a particular product line will exceed the gross income generated by that product line in a particular year. Treas. Reg. § 1.861-8(d)(1) specifically states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [dealing with the 'factual relationship between the deduction and a class of gross income'] even though, for the taxable year, *no gross income in such class is received*" (emphasis added). The specific regulation relied upon by the government for the allocation of R&D expenses also provides that "[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping." Treas. Reg. § 1.861-8(e)(3)(ii)(B). This is consistent with the current deductibility of R&D expenses and the result of the annual accounting for taxes.

255 F.3d 1357, 1359-60 (Fed. Cir. 2001) (holding that a consolidated return regulation cannot be used to subvert the intent of another statute); *see also United Dominion Industries, Inc. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J. concurring) (when construing a complex statutory and regulatory scheme that lends itself to several interpretations, "we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter."). By mandating the use of a special allocation rule for R&D expenses in respect of DISCs and FSCs, the government does violence to those statutory schemes. The Eighth Circuit in *St. Jude Medical* is correct: Treas. Reg. § 1.861-8(e)(3) is invalid as applied to the computation of CTI.

CONCLUSION

For the foregoing reasons, the Court should reverse the decision of the U.S. Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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